An assessment of informal sector income tax as a means of enhancing public value:
Lessons from Kenya Revenue Authority

by
Monica Were

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Supervisor: Prof. Johan Burger

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Declaration

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Abstract

The vitality and growth of small to medium-size enterprises together with advancements of the Kenyan economy shows the need for government to respond appropriately in terms of revenue generation. The response should redistribute the tax burden to all stakeholders within the economy. This is because revenue or tax is used not only to fund education and health, which are key pillars for the promotion of public value in both the short and the long term, but also helps in supporting the growth of the local economy through development of infrastructure that supports the local business networks and cash transfers and subsidies which help induce supply and demand in local markets. Tax administration and policy should be among the biggest concerns for any economy looking to attaining public value for its citizens. Every country desires to have a tax administration instrument that is efficient in collecting taxes and a tax payer base that is fully compliant.

This paper presents an analysis of imperatives and theories concerning the Informal sector with regard to revenue collection in Kenya. The aim is to determine the potential benefit of informal sector tax revenue collection by government for the public value of the citizens in Kenya and, in addition, to show the effect of informal sector income tax on public value if this is should be achieved by the Kenya Revenue Authority.

The paper presents a comparative analysis of researched techniques to explore techniques that the government can use for collecting income tax from the informal sector in Kenya. It also highlights the current income tax system used by the Kenya Revenue Authority in the quest to collect income tax. It shall draw from secondary data findings and through analysis that Kenya needs to re-examine its tax administration and policy if it is going to make progress in increasing revenue generation from the informal sector as a tool to enhance public value.

Tax compliance in the informal sector is an outcome of a cost-benefit decision. The choice of whether or not they pay taxes is thus driven by a simple-cost benefit analysis. Therefore, success of informal sector tax system is based on the efficiency of fiscal administration coupled with technological, economic, social and political incentives.

Opsomming

Die lewenskragtigheid en groei van klein tot mediumgrootte ondernemings, tesame met die vooruitgang van die Keniaanse ekonomie, toon 'n behoefte vir die regering om toepaslik ten opsigte van inkomstegenerering te reageer. Die reaksie behoort die belastinglas van alle belanghebbendes binne die ekonomie te herverdeel. Dit is omdat inkomste of belasting nie slegs gebruik word om onderwys en gesondheid te finansier nie. Dit is ook die sleutelpilare vir die bevordering van openbare waarde op beide kort en lang termyn, en help om die groei van die plaaslike ekonomie deur die ontwikkeling van infrastruktuur wat die plaaslike sakenetwerke en kontant oordragte sowel as subsidies ondersteun en vraag en aanbod in plaaslike markte in die hand voer. Belastingadministrasie en -beleid behoort tot die grootste oorwegings vir enige ekonomie wat openbare waarde vir sy burgers wil bereik. Elke land begeer om 'n belastingadministrasie-instrument te hê wat doeltreffend is in die invordering van belasting en 'n belastingbetalersbasis wat ten volle meewerk.

Hierdie navorsingsverslag bied 'n analise van die imperatiewe en teorieë rakende die informele sektor ten opsigte van inkomste-invordering in Kenia. Die doel is om die potensiële voordeel van die regering se insameling van die informele sektor se belastinginkomste vir die openbare waarde van die burgers in Kenia te bepaal en om die effek van informele sektor inkomstebelasting op openbare waarde te toon, indien dit deur die Keniaans Inkomste-owerheid bemoontlik sou word.

Die verslag gebruik 'n vergelykende analise van nagevorsde om tegnieke verken wat deur die regering gebruik kan word om inkomstebelasting van die informele sektor in Kenia in te samel. Dit beklemtoon ook die huidige inkomstebelastingstelsel wat deur die Inkomstediens in Kenia gebruik word om inkomstebelasting in te samel. Bevindings uit sekondêre data en analise dui aan dat Kenia sy belastingadministrasie en -beleid moet hersien indien vordering met die generering van inkomste uit die informele sektor verbeter moet word om openbare waarde te verhoog.

Die getroue invoering van belasting in die informele sektor, is ‘n voorbeeld van ‘n koste-effektiewe besluit. Die keuse om belasting te betaal is dus gedrewe deur ‘n eenvoudige koste-voordeel analise. Die sukses van die informele sektor se belasting sisteem is dus gebasseer op die effektiewiteit van fiskale administrasie gekoppel met tegnologie, ekonomie en sosio-politise aansporings.

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Abbreviations

EGDI	– E-Government Development Index
ETR	– Electronic Tax Register
EU	– European Union
FDI	– Foreign Direct Investment
GDP	– Gross Domestic Product
GTZ	– German Technical Cooperation Agency
IEA	– Institute of Economic Affairs
ITA	– Income Tax Act
iTax	– Integrated Tax Management System
ITMS	– Integrated Tax Management System
KNBS	– Kenya National Bureau of Statistics
KRA	– Kenya Revenue Authority
KShs	– Kenya Shillings
LTU	– Large Tax Unit
NGOs	– Non Governmental Organisations
OECD	– Organisation of Economic Cooperation and Development
PAYE	– Pay As You Earn
PCA	– Post Clearance Audit
PIN	– Personal Identification Number
PIT	– Personal Income Tax
RARMP	– Revenue Administration Reform and Modernisation Programme
SARs	– South Africa Revenue Services
SBP	– Single Business Permit
SMEs	– Small and Medium-Sized Enterprises
TJN-A	– Tax Justice Network – Africa
TOT	– Turnover Tax
UK	– United Kingdom
UNESCO	– United Nations Educational, Scientific and Cultural Organisation
US	– United States
USD	– United States Dollar
VAT	– Value Added Tax
WHT	– Withholding Tax

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Chapter 1: Introduction

1.1 Introduction and background

Generation of tax is fundamental in the successful creation of public value by governments. Revenue generated from taxation enables the production and supply of goods and services demanded by citizens. It is in the best interest of the government to meet ever-rising public demands. The tax collection authorities must endeavour to collect maximum revenue from all potential taxpayers.

Similarly, it is prudent for the government to ensure tax burden equity. Tax burden equity proposes that taxes be levied in an equal and equitable manner both horizontally and vertically. The government should strive to ensure tax burden equity in revenue collection from its citizens. All citizens' benefit in one way or another from goods and services provided for by the government. Hence, it is prudent for earners from both formal and informal sectors to meet their tax responsibilities. The informal sector has been defined as an industry of employees not covered by labour or domestic legislation. The definition was subsequently revised and extended to cover all informal employment (Xue, Gao & Guo, 2014:85).

The total revenue generated also provides a useful measure of a country's financial performance. Kenya has ambitious plans to become a developed country by 2030, hence the launch of the Vision 2030 agenda, which is aimed at improving the public value of Kenyans ' lives. The vision envisages the implementation of policies, programmes and initiatives to enhance financial efficiency, social welfare, political structures and a sustainable environment. Adequate income generation is essential for the government to realise these 2030 vision goals.

The government should then have an efficient and effective revenue collection authority. The Kenya Revenue Authority (KRA) is a very vital institution in enabling the government's success. The KRA was established by an Act of Parliament in 1995 (Kenya Revenue Authority Act). The purpose of the authority is to enhance the mobilisation of tax revenue while providing effective tax administration and sustainability in revenue collection. The KRA is mandated to maximise revenue collection to ensure that the government can afford the desired future. Kenyans themselves should raise the bulk of their public budget revenue.

Kenya has been a democratic state since independence in 1963. The government of the day is elected by the people and for the people. The political environment in Kenya is highly volatile as a product of democracy and the opposition very visibly and loudly ensures checks and balances. The political party in office is under immense pressure to perform as promised in their campaign agendas and manifestos, otherwise risk losing out in the subsequent elections. Over the years, Kenya's literacy rate has also risen. According to the UNESCO Institute for Statistics, it is now estimated at 72.16% (UNESCO,2018). A majority of the individuals are enlightened and know what they want. The erudite individuals are constantly pressuring the government to deliver on their manifestos presented in the election campaigns, so there is a higher demand for the government to deliver. Revenue is essential to fulfilling the agenda of government (Mpapale, 2014:12).

In recent times, the Kenyan budget has continually expanded. Budget 2018 is estimated at 2.29 trillion compared to the ten-year-old trillion (Development Initiatives, 2018). This is a clear measure of exponential growth in the economy's demand for products and services; therefore, the government has no choice but to improve and create methods of raising resources to satisfy requirements. Increased revenue has also led to an improvement in public value; Kenya's standard of living has increased; government agencies provide access to free maternity care, primary and secondary education.

The KRA's purpose is to evaluate, collect, administer and enforce revenue laws (Kra.go.ke, 2018). The KRA is authorized on behalf of the state and the citizens of Kenya to collect income. Kenya's tax structure was intended to depend on corporate tax; pay as you earn; withholding tax; value added tax and turnover tax as the main tax instruments (Mpapale, 2014:12).

In the informal sector, Kenya's tax base still has enormous potential for growth, despite the Treasury and KRA's present efforts to seal income leaks. Tax base is the total amount of assets and income that can be taxed by a taxing authority. The KRA has long faced the challenge of collecting tax revenue for all the country's financial operations, particularly from the informal sector.

Most countries in the world, including the developed world countries in America and Europe, are facing challenges in collecting revenue from the shadow economies that include informal sector enterprises. The informal sector continuously persists in carrying out their businesses without registration with the revenue authorities in order to evade taxation. With these businesses estimated to be about 15 to 30 percent of the country's business activity, these countries are certainly losing out on significant revenue (Roux, 2013:24-25).

In its 1972 report on Kenya, the International Labour Organisation (ILO) traced the concept of informal industry for the first time in Kenya. Kenya and Ghana were among the first African countries to exhibit entrepreneurship and enterprise.

Kenya's informal industry is called the "jua kali" sector. Jua kali is a Swahili word meaning' scorching sun,' meaning it entails hard work and the individuals employed in this industry mostly work under the scorching sun. This has really resulted in the industry being misinterpreted and misrepresented. For example, it is assumed that the informal sector does not contribute significant income and/or profit compared to the formal sector, and that the income generated in the sector constitute of meagre wages. Kenya's informal sector businesses include lounges, kiosks, hawkers, artisans, goldsmiths, tailoring, and subsistence farming, to name but a few.

Studies undertaken by the Institute of Economic Affairs (IEA) found that the informal sector in Sub-Saharan Africa accounts for about 35 to 50% of the GDP of most countries. It has been estimated that the informal industry in Kenya is just above 30% and an important contributor to employment, employing about 80% of the working population. The informal industry in Kenya is estimated to contribute more than 25% to GDP (Mpapale, 2014:7).

The propositions above on the informal industry in Kenya presents the industry as a major contributor to the economy's overall performance. Consequently, the government should concentrate deliberately on ensuring that the industry contributes not only to job creation for the majority of the population, but also to ensuring that the particular majority is obliged to honour their revenue tax liability.

Public value has varied definitions. Moore and Talbot define these as,

> '… managerial success in the public sector with initiating and reshaping public sector enterprises in ways that increase their value to the public in both the short and the long run.'
>
> (Moore,1995:10)
>
> 'Public Value then is the combined view of the public about what they regard as valuable.' (Talbot, 2006:206)

Government agencies do not secure funds by selling products and services as in private enterprises, but by selling to the electorate an agenda of creating public value (Moore & Khagram, 2004:5). Public value is therefore more a perception among voters of the value they derive from government. Public value is often obtained from resource utilisation and accountability and remains quite challenging. The task facing government managers is to measure and demonstrate public value. The subject of public value is not only an opinion held by government agencies, but also a view shared by the general public. It is essential for government to determine and measure public value (Moore & Khagram, 2004:8-23), but in addition to government, the general public must also agree that there is public value in their nation.

Public value suggests that government representatives need to implement a general public good agenda. Government must warrant their occupation of state offices in democratic nations. Managers in most governments are authorized by their constituents to act on their behalf through a democratic process, with the goal of enhancing the welfare of people. Continuous dialogue and engagement between the state and citizens is necessary for public value programmes. Public authorities then use the principles agreed on to create choices that enhance governance systems and quality of life (Moore & Khagram, 2004:8-23). Government must take steps to enhance tax bases by implementing tax policies, initiatives and programmes aimed at enhancing public value (Coats & Passmore, 2006:4-6).

1.2 Motivation for the research

There are epistemic inequalities and issues of voice and power in knowledge production on taxation in and on Africa. This paper aims to fill the gaps and add onto the existing body of knowledge especially from Global South while at the same time acknowledging the Global North contributions in income tax epistemology.

Like most other governments around the globe, Kenya's government relies on tax to fulfil the duty to generate 'adequate' income. The Kenyan government plans to spend Kshs 2.29 trillion. The government aimed to increase income in excess of Kshs 1.7 trillion, while project grants were anticipated to increase by 14.3%. Approximately Kshs 0.59 billion total budget deficit (Development Initiatives,2018)

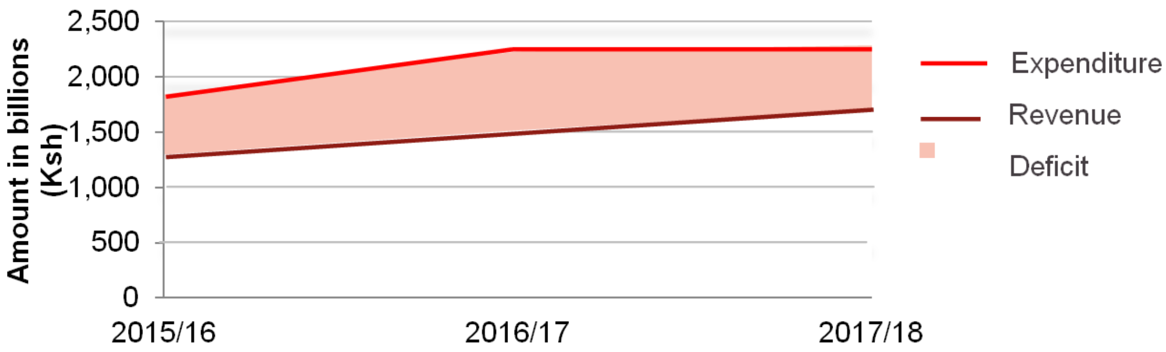


Figure 1.1 Kenya's budget deficit

Source: Development Initiatives based on figures in budget documents for financial years 2015/16–2017/18.

The purpose of the government is to collect sufficient revenue to eliminate deficits and allow it to provide products and services that will enhance citizens ' welfare, hence public value. The mandate of the KRA is to collect tax income on behalf of the Kenyan government and individuals. This is inked in Chapter 469 of Kenya's legislation (Kenya Revenue Act) and in accordance with the Bill of Rights in 2010 Constitution of the Republic of Kenya (Constitution of Kenya, 2010). The authority's duty is to collect tax revenue from all revenue earners indiscriminately, hence revenue earners from both the formal and informal industries. KRA continuously contended with this mandate, particularly within the informal sector, and it remained a daunting task for KRA to generate funds from the sector.

Contrary to the common view that Kenya's informal sector is a second-rate industry, in 2012 the Kenya Bureau of Statistics demonstrated otherwise. It determined that 25% of domestic GDP is commanded by the industry (Mpapale, 2014:6-7).

The Institute of Economic Affairs also suggested that about 75 percent of Kenyans are employed in the informal non-agricultural industry, according to the study undertaken in 2010. The Institute of Economic Affairs revealed in 2011 that over 60% of Kenya's youth work in the informal industry. Taking these results into account, the informal industry is a very important contributor to Kenya's economy. Ultimately, this could result in economic growth and enhanced public value if the KRA tapes into it (Mpapale, 2014:7).

Currently, the state has only succeeded in collecting taxes from the informal sector through pre-business start-up licensing and trade permit issuance, but the KRA has no scheme to monitor potential tax start-ups (Mpapale, 2014:7).

1.3 Problem statement

In their forward march to socio-economic development, a majority of African governments find the informal economy to be both fledgling and challenging in terms of collecting income tax. Taxing the informal sector remains an urgent issue. A majority of African economies therefore are fiscally constrained in their efforts to liberate economic restraint. The governments through their tax administrators are exploring ways to augment state revenue. They are targeting the informal sector on account of the continuous and exponential growth within the sector. This is because they have recognised potential revenue that is currently lost through tax evasion by informal sector enterprises (Ofori, 2009:4-9).

Kenya’s informal sector taxation has also remained a key challenge for government since independence. The size of the informal industry is not commensurate with the miniscule tax inflow. Engaging in tax evasion in the informal industry can take the form of misrepresentation to hide facts (i.e. tax fraud). For example, a company may understate its earnings to pay less or no taxes. Most informal companies in Kenya are not registered as official companies; therefore, the state does not have the means to assess and access their company operations.

Furthermore, tax avoidance happens when people and businesses take advantage of the tax system's loopholes to avoid paying taxes. Tax avoidance relates to the legal means, wherever possible, of reducing tax liability. For instance, companies can use tax credits to decrease the quantity of tax paid. Many informal sector businesses either intentionally avoid tax payments or are not obliged to pay taxes because there are no specific regulatory policies in place to monitor the sector's operations (Siehl, 2010:9).

Although the notion of the informal industry has been discussed since its ‘discovery’ in Africa in the early 1970s, it continues to be used by policymakers and researchers as it includes the bulk of the global workforce remaining outside the domain of full-time, stable and protected employment. Currently, interest in informal labour agreements or informal labour markets is renewed. This present interest arises from the reality that casual jobs have not only persisted and metamorphosed, but the jobs are also in unexpected and disguised forms (Siehl, 2010:39).

Several researchers looked at variables that were deemed to account for the informal sector's continued development, but there was no conclusive proof of these variables. Even the informal sector's precise definition remains a dispute. According to Schneider and Enste, ‘disagreement persists over the informal economy's definitions and assessment processes’ (Schneider & Enste, 2000:24).

Governments have made desperate attempts over the years to capture the informal enterprises efficiently into the tax net, but very little in that direction has been accomplished. The techniques of taxing the informal industry are full of seemingly insurmountable difficulties and weaknesses; hence the unique issue continues as to how to tax the informal industry in order to raise the necessary income for domestic growth.

Again, it is probable that the informal sector will develop quickly than it is now if government can develop concrete policies to promote the sector's financial operations. Revenue capacity is anticipated to rise dramatically as a result of public policy reforms.

Kenya's development initiatives have not completely integrated the important role of the informal industry. This is partially reflected in the low efficiency of the industry, a feature that obviously reflects the fact that after 50 years of independence, there is still no extensive policy framework for an industry that comprises about 77% of Kenya's workers (Mpapale, 2014:9-11).

Indeed, in terms of their corresponding income tax contribution to domestic growth, some elements of the informal sector have the ability to upgrade, graduate into the formal sector and formalise. The informal sector's unique fundamental social imperatives, such as minimal regulation; predominant cash transactions; non-existent or poor record keeping; itinerant nature; little or no entry barriers, etc., make the industry highly hard to tax. This scenario has facilitated huge tax avoidance of all types, including earnings non-reporting and revenue under-reporting.

It is probable that the informal sector will develop quicker than at present if government can develop concrete policies to encourage the sector's financial operations. It is anticipated that income capacity will rise dramatically as a result of public measures to build the capacity of informal sector business (Ofori, 2009:5-12).

1.4 Research question

How does the income tax system structure ensure informal sector contributes equitably to revenue generation and public value enhancement?

1.5 Aim and objectives of the research

Against the research question outlined above, this thesis aimed to review and evaluate studies centred on the future income development and governance advantages of informal sector taxation; consider alternative approaches for taxing informal sector companies; and explore technical and political financial obstacles to appropriate reform. The ultimate interest was not to advocate for or against the informal economy's increased taxation, but to consider how to make these systems more efficient and equitable. This is crucial in helping to determine how attempts to tax informal sector operators produce fresh advantages instead of adversely affecting formal systems (Joshi, Prichard & Heady, 2014:1326). This paper seeks to determine the possible public value advantages in Kenya from the taxing the informal sector.

The following are the research objectives for this study meant to realise the aforementioned aim:

i. Introduction to the informal sector and taxation in Kenya;
ii. Understanding the informal sector and taxation;
iii. Characteristics and delimitations of the Kenyan tax system;
iv. Analysis of advances necessary for informal sector revenue collection to promote public value; and
v. Results, conclusions and recommendations.

1.6 Research design and methodology

This is a descriptive desktop research on informal sector tax compliance for public value. The research was executed using published literature's theories, concepts, and numerical analysis. This involved collecting and analysing secondary data to determine the future impact and attempting to predict how the KRA will enhance the informal sector's income collection if it adopts plausible approaches suggested by studies. The use of comparative and cross-sectional studies was also integrated by comparing distinct theories on the topic and also comparing the methods employed by other nations to enhance the informal sector's tax collection. A cross-sectional research can be described as a strategy using a comparison of an occurrence in different parts to determine the likelihood of replicating the same result in a different context (Pesut, 1997:203). The research applied methodological triangulation to maximise the advantages of both qualitative and quantitative analyses.

1.7 Rationale for secondary data and methodological triangulation

This was a desktop research because of resource constraints, the study was based on a review of significant literature and secondary data. The study concentrated primarily on Kenya's informal sector and revenue authority in Kenya. The KRA, like other organisations in the public sector in Kenya, are very reluctant about sharing information and data with researchers owing to the fear that the information could be used against the establishment. The benefit of using secondary data is that it enables learning opportunities and tries to provide alternatives for the study. While it is essential to note that information can be inaccurate, the investigator conducted a comprehensive review of literature on the topic and included propositions from both critics and advocates.

The research was performed to maximise the advantages of both qualitative and quantitative methods by using methodological triangulation. The study's qualitative method applied is literature content assessment. The qualitative strategy offers a greater understanding of the study. Using two methods also complements each's limitation. The quantitative numerical analyses strategy offers objectivity and includes statistical analyses. Methodological triangulation makes it possible to improve precision by cross-checking distinct dimensions of studies.

1.8 Structure of the thesis

This thesis is structured as follows.

Chapter 1: Introduction

The first chapter provides a background to the study, the motivation for the study and the research problem, research question, and the aim and objectives, the research design and methodology that was used in the study.

Chapter 2: Understanding the taxation and informal sector: A literature study

The second chapter sets out to define and clarify the notion of the taxation, informal sector, and public value. This chapter provides a literature review on informal sector perceptions around taxation and public value. It investigates the income tax perception, perception of public value, and assesses tax incidents within the informal sector in Kenya. Definitions of key concepts, theories, approaches and systems are also provided.

Chapter 3: Characteristics and delimitations of the Kenyan tax system The third chapter unpacks Kenya's tax incidence, legislation and policy reforms, variations in taxpayer compliance and tax policy reform challenges.

Chapter 4: Analysis of advances necessary for informal sector revenue collection to promote public value.

The fourth chapter presents an analysis of findings for informal sector tax evasion, the extent of budget deficit due to non-compliance and the most effective responses to tax evasion in the Kenya informal sector.

Chapter 5: Results, conclusions and recommendations

The final chapter comprises the presentation of analysed and summarised research findings. Conclusions regarding whether the study met the research objectives are drawn and recommendations are made on how to improve perceptions held by informal taxpayers. The limitations of the study are also highlighted.

In respect to this paper 100 Kshs is equal to 1 dollar as at 25.07.2018.

Chapter 2: Understanding taxation and informal sector

2.1 Introduction

Significant literature reviewed highlighted the intricate linkage between the formal and informal sectors. Formal enterprises involve the informal economy in complicated subcontracting agreements in a number of cases. In most instances, the informal businesses are a conduit of the formal businesses, for example, most of the informal businesses are extensions of the formal ones, for instance, in their attempt to avoid taxation the formal enterprises have informal sector vendors in the streets hawking goods on their behalf.

In view of these complexities and somewhat blurred lines, this chapter focuses on companies and their owners, including the self-employed, as they are more likely to have sufficiently high revenue to meet their tax liability. The small and micro-enterprises that produce sufficient revenue to warrant taxation but find it easy to evade their tax liability due to their location, size and/or nature of their business. To understand both the motivations of such companies and the merits of taxing them, it is essential to bear in mind the concept of taxation and the wider consequences of formalisation. In the recent times, growing attention has been given to tax complexities within the informal industry in developed and developing nations. This section aims to present discussions and proposals on whether and how to enhance public value through informal sector taxation by highlighting latest state-oriented initiatives and innovations.

The question of whether informal economy taxation is justified has been the topic of a long-standing debate. In critics ' perspective, tax revenue from informal sector is insignificant, with high administrative costs, and probably taxation of these firms is inherently regressive. Regressive tax imposes a greater proportion of taxes on low-income earners than on high-income earners (Joshi *et al*., 2014:1325-1329). Most governments in developing countries are cash-strapped, thus showing strong interest in the informal sector's future income generation. In addition, the informal sector is an important and increasing share of GDP (Joshi *et al*., 2014:1325-1329).

Another dominant opinion is that development is adversely affected by taxation. Taxation decreases the reward for entrepreneurship and innovative start-ups, resulting in decreased investment needed and imperative for development. These propositions suggest that an appropriate response by governments is to entice the innovators through tax subsidies to promote more innovation (Aghion *et al*., 2016:24).

An alternative perspective claims that taxation is not independent of the financial and institutional setting surrounding it. Indeed, taxation is central to many elements of this setting: tax revenues fund government infrastructure, education and schools, legal systems, and much more. Entrepreneurs and innovators often depend highly on these government products, and greater taxation can boost development if it promotes greater public goods provision as it increases anticipated returns on entrepreneurial attempts (Aghion *et al*., 2016:24).

In the perspective of advocates, informal sector taxation is critical to maintaining the formal sector's tax morale and tax compliance. As far as growth is concerned, there is now some proof that formalisation can accelerate development for some informal sector companies and may have wider advantages for current formal sector companies. Lastly, with regard to governance, novel arguments have suggested that tax compliance by the informal economy may be a way for companies to collaborate with the state, thereby encouraging legitimacy, good governance and political accountability.

The economy's infrastructure is an outcome of efficient collection and use of revenue by government. Such infrastructure aids the innovation efforts of firms that contribute to improve public welfare of the entrepreneurs and even the greater public. Taxation can be an instrument to contribute to a green, safe and sustainable environment. Depending on the policy's goal, such as reducing carbon emissions, weighted taxation is applied to various fuel sources that condition and change the preference of people and reliance on distinct sources of energy. Higher taxation tends to limit use of specific sources of energy and vice versa (Aghion *et al*., 2016:26).

The second chapter sets out to define and clarify the notion of the taxation, informal sector, and public value. This chapter provides a literature review on informal sector perceptions around taxation and public value. It investigates the income tax perception, perception of public value, and assesses tax incidence within the informal sector in Kenya. Definitions of key concepts, theories, approaches and systems are also provided.

2.2 Taxation

Taxation is a policy tool used to achieve public goals both socially and economically. Most developing countries have complementary tax and public policy objectives. There are five main purposes for taxation: first is to gain economic power for resource redistribution; second, for social development; third, is to enhance stability of the economy; forth, so as to have the ability to influence markets; and lastly to spur economic growth.

According to Richard Bird's book' Tax Policy and Economic Development,' the three most urgent goals of developing countries governments are wealth redistribution, financial development and stability (Kayaga, 2007:6-7).

Taxation does not always provide people with public goods and services. Governments have diverse and significant requirements that are all based on scarce resources (tax income). Nevertheless, tax payment is a shared duty of the state and all its citizens. This responsibility cannot be left to one organisation, industry or person to ease the tax burden and realise the collection of tax revenue. Every sector must take up its responsibility if the beneficial goods and services are to be attained (Mutua, 2012:9).

2.2.1 Theories of taxation

The following theories explain differences in taxpayer compliance with tax liabilities. To understand better the appropriate response to the research question this paper will examine the following taxation theories:

2.2.1.1 Economic deterrence

This theory posits that the choice on compliance by taxpayers is based on evaluation of costs and benefits. Taxpayers consider the compliance benefit and non-compliance costs. Tax administrators have commonly implemented these theoretical concepts in creating tax reforms. The theory's proposal concludes that it is extremely probable that people who weigh costs and benefits and conclude tax evasion implications as expensive express tax compliance attitudes (Ali *et al*., 2014:829).

2.2.1.2 Fiscal exchange

Compliance by taxpayers rises to the extent that they receive associated public benefits. There is a direct connection between adherence to tax liability and government delivery of public goods and services. The greater the level of public satisfaction and trust in the quantity and quality of products and services, the greater the tax morale and compliance (Ali *et al*., 2014:829).

2.2.1.3 Foreign aid

Most African countries are foreign aid recipients. Taxpayers are dependent on non-state donors for goods and services that should be ideally provided by government. As a result, their readiness to settle their tax commitments to government is jeopardized; they do not profit from government, so they have no regard for tax payments. Among others, non-state service providers include NGOs. They deliver products and services that the government would normally provide. These advantages decrease the probability of getting an attitude that is tax compliant (Ali *et al*., 2014:829).

2.2.1.4 Social Stimuli

This theory suggests that a reference group influences or infer the behaviour of people in society. Individuals in a society of tax compliance are likely to fulfil tax commitments. This is because their colleagues and citizens generally believe that they conform to the tax laws. The opposite is also true, there are high rates of tax default in nations with low tax morale. Tax compliance is more probable to result in equality and fairness in the administration of tax commitments by tax officials (Ali *et al*., 2014:829-830).

2.2.1.5 Comparative treatment

The theory of comparative treatment suggests that taxpayers compare the treatment they receive from the tax authorities against other taxpayers. The perception on how they are treated vis-à-vis others determines their attitude and response to tax compliance. For example, if taxpayers perceive equality and fair treatment by government agencies, tax burdens are likely to be met (Ali *et al*., 2014:830).

2.2.1.6 Political legitimacy

This theory argues that the extent to which taxpayers trust the political class in authority influences tax adherence. Political legitimacy is an outcome of citizens' trust in government officials and institutions. Consequently, citizens consider the social arrangement established to be acceptable and fair and for the common good. The higher government's political acceptance among people, the higher the likelihood of tax compliance (Ali *et al*., 2014:830).

2.2.2 Dominant informal sector persuasions

The informal economy, often for distinct purposes, can be regarded in either favourable or negative terms. The following are persuasions about the informal economy underscoring these differing views.

2.2.2.1 The dualist

The International Labour Organisation popularized this notion in the 1970s and subscribes to the idea that the informal sector includes marginal activities that are distinct from and not related to the formal sector. That the informal sector provides income for the poor and is a safety net in times of crisis. Further that the informal sector exists as an avenue for the poor to earn a living, at the same time act as a buffer for those laid-off from their jobs in times of economic recession. This concept posits that the persistence of informal sector activities is predominantly due to the fact that insufficient formal job opportunities exist to absorb surplus labour due to slow economic growth rate and/or faster population growth rate (Ofori, 2009:9).

2.2.2.2 The structuralist

The structuralists argue that the informal sector should be regarded as smaller financial units. Informal sector workers serve to decrease input and labour costs, thereby enhancing the competitiveness of large capitalist companies. The structuralist model considers the formal and informal sector not only as coexisting, but also as inextricably linked and interdependent. The nature of capitalist formal sector accounts for the persistence and growth of informal businesses (Ofori, 2009: 9-10).

2.2.2.3 The legalist

The legalist posit that the informal sector includes daring micro-entrepreneurs who choose to operate informally to avoid the costs, time and effort associated with formal business. Micro-entrepreneurs will continue to produce informally as long as tax payment processes are complicated and expensive. Arbitrary government rules and regulations stifle the taxpayers' efforts in adhering to tax rules. The excessive demand imposed on companies by the enactment of countless legislations and regulations force many businesses into the informal sector. The simplification of formalisation process, rules and regulations can lower the level of informality among businessmen (Ofori, 2009:10).

2.2.2.4 The illegalist

The illegalist school, popularized by neo-classical and neo-liberal economists, subscribes to the perspective that informal entrepreneurs are intentionally seeking to avoid tax laws and taxation and, in some instances, handle illegal products and services. This school is linked to the notion that an underground or black economy is an informal economy. Informal businesses choose to work illegally–or even criminally–to avoid taxation, trade laws, and other formal working expenses (Ofori, 2009:10-11).

2.2.3 Taxation in developing countries

For this research, a comparative study was selected from South Africa, Kenya, Tanzania and Uganda. For the past two decades, these nations have implemented tax reforms with the primary objective of raising the tax base and enhancing compliance. With the exception of South Africa, the other three nations, face major challenges in attaining tax reforms.

Similarities and differences in these countries provide profound understanding of improvement in tax compliance within the informal sector. The informal sector in Kenya, Tanzania and Uganda is mainly comprised of unregistered organisations such as small-scale traders, small-scale producers, small-scale miners', farmers, restaurants, and food suppliers (TJN-A, 2012:6). However, recent research show that professionals such as lawyers, doctors, engineers, economists and accountants also work informally. A significant number of these professionals have fulltime formal jobs but also engage in informal part-time work (TJN-A, 2012:6-12).

The informal economy is estimated to be significant in East African states, indicating that a substantial amount of revenue is lost when they are not taxed. Because of the features and characteristics of East Africa's informal sector, which among other variables, includes minimal transactions, and the reluctance to maintain business records, it is highly difficult to tax the players in the sector (TJN-A,2012:8-12).

2.2.3.1 South Africa

This nation provides an exciting comparison as it has a more advanced and comprehensive tax system. South Africa has a GDP per capita that is comparatively greater than the three other nations analysed here. South Africa, however, faces high levels of inequality in terms of income. Moreover, South Africa has a relatively high level of democratic governance. The tax revenue produced in 2011 represented 27.3 percent of GDP.

Like Kenya and the other two nations, South Africa faces the challenge of informal sector tax evasion. To curb this, successful taxpayer outreach and education programmes have been introduced by the South African Revenue Services (SARS). SARS has also implemented enforcement policies to alter the attitudes and behaviours of people towards taxation (Ali *et al*., 2014:830).

2.2.3.2 Kenya

Kenya's tax income in 2011, second after South Africa, was estimated at 20.1% of GDP. Although this proportion is significantly greater than in most African nations, Kenya's tax burden distribution is extremely uneven, leaving a big part of the economy untaxed. Kenya is a democratic state, although the level of democracy is at a slightly lower level compared to South Africa. Unlike South Africa, Kenya continues to jostle with low revenue equity (Ali *et al*., 2014:830). In order to substitute both income tax and VAT, Kenya levies a 3% flat turnover rate on turnover of KShs 5 million and above. The development of a streamlined single license for small companies has enhanced circumstances for these companies and encouraged some formalisation (Joshi *et al*., 2014:1333-1335).

More latest study has shown that newly licensed companies are still subject to corruption and harassment by government authorities in some instances. However, the follow-up study is restricted, the long-term impact of reform has not been determined (Joshi *et al*., 2014:1335).

2.2.3.3 Tanzania

The government of Tanzania has been working tirelessly through the Revenue Authority to improve tax compliance. The tax to GDP ratio was at 15.2 percent in 2011. High levels of noncompliance have resulted in the country's dependency on foreign aid. The African Development Bank (2010) estimated that foreign aid comprises approximately 34 percent of the total government budget (Ali *et al*., 2014:830). Tanzania operates a system in which tax is a progressively increasing proportion of turnover, and those without adequate records pay a larger amount (Joshi *et al*., 2014:1333).

Tanzania's privatisation of government enterprises led to massive retrenchment from government institutions leading to expansion of informal sector. Consequently, public sector is no longer the major employer and the inability of the labour market to absorb the unemployed, forced the unemployed to resort to informal employment. Formal sector employees also struggle to make ends meet due to the low income associated with formal employment and they look for more rewarding opportunities within the informal sector (TJN-A, 2012:10-12).

2.2.3.4 Uganda

Uganda has a tax-to-GDP ratio of 12.9 percent, which is very small compared with South Africa, Kenya, and Tanzania. Unlike the rest, Uganda is the least democratic. For more than three decades, the nation has had the same presidency (Ali *et al*., 2014:830). A significant fragment of the informal sector in Uganda is illegitimately exempted from taxation and compliance with tax legislation in exchange for votes (Goodfellow & Titeca, 2012:266).

Uganda introduced the simplified single business permit as a form of registering small firms through a pilot project. The pilot project resulted in a 43 percent increase in compliance and formalisation, but the resultant impact of this tax reform has not been reflected due to limited follow-up research in Uganda (Joshi *et al*., 2014:1335).

Table 1.1 Reasons for tax evasion (percentage of sample)

	South Africa	Kenya	Tanzania	Uganda
Unfair tax system	8	8	11	11
Taxes are too high	22	23	25	28
Taxes are unaffordable	27	26	25	29
Poor public services	12	9	16	11
Government wastes/steals taxes	11	10	9	8
People know they will not get caught	1	2	2	1
Other	20	23	12	12
Total	100	100	100	100

The findings presented in Table 1 were determined through a study conducted by Ali *et al*., (2014).

The table summarizes the reasons why informal sector enterprises fail to meet their tax obligations.

The unfair tax scheme adds an average of 10 percent to tax evasion, as informal companies in these four nations regard the tax scheme as unfair and biased.

One in four informal industry companies in all four nations have low tax morale because they perceive that the taxes are exorbitant.

The view of tax affordability has the biggest impact on compliance or non-adherence to tax liability. When observed to be too high, most informal businesses opt for evasion or avoidance.

Most Tanzanian companies do not meet tax obligations because they consider their government's public-value goods and services to be of poor quality and quantity. In South Africa, Uganda and Kenya, the same trend is noted.

South Africa and Kenya are suffering the largest proportion of government corruption rates. This certainly has adverse ramifications because most informal firms will motivate tax evasion by citing government officials ' misuse of tax revenue.

The number of individuals who know they will not be caught is a clear indication that all four nations have powerful detection ability and stringent tax violator legislation. An average of over 98.5 percent of tax evaders have a perception that if they are discovered to be tax offenders, legal action will be taken against them.

2.3 Taxation and public value

If taxpayers are considerably satisfied with the public services of their governments they are likely to meet tax commitments (Ali, Fjeldstad & Sjursen, 2014: 829).

Recent literature suggests that informal sector taxation may yield long-term and substantial advantages for public value. Taxing informal businesses leads to enhanced income, economic growth, and quality governance. There is also some proof that informal sector taxation can lead to enhanced mobilisation and accountability for the public. Taxation in the informal sector could also be an imperative for extending citizens ' political voices (Joshi *et al.*, 2014:1325-1341).

2.3.1 Financing public value

The government budget balance required for public goods and services expenditure (Bt) in a specified year (t) depends on government revenue (Rt) and expenditure (Et) for that year:

Equation 2.1

$$B_t = R_t - E_t$$

If Bt > 0, that year's budget surplus is due to the state collecting more by taxation than it spends. If Bt < 0, a budget deficit denotes that the state has spent more than it has generated by taxation (Vargas-Silva, 2015:848).

A key causal variable for people's choice to work or not to work in the informal economy is also the provision and, in particular, quality public sector facilities. World Bank government-efficiency indicators capture public service quality perceptions as a benefit from taxation. This index scores ranges from -2.5 to +

2.5, with greater scores corresponding to better results (Schneider *et al*., 2010:443-461).

One-hundred percent tax compliance in the real world is neither realistic nor desirable. The key issues for policymakers are about what goods and in what amounts governments should provide, and what amount and combination of taxes should be used to pay for them. Substantial tax evasion by the informal sector can lead to a reduction in government revenue, which in turn reduces the quality and quantity of goods and service provided. For example, owing to limited income, government facilities and tax management schemes can be jeopardized. This can ultimately lead to a rise in the formal sector tax rates. It propagates even greater incentives for informal businesses to take part in the shadow economy over the longer term (Schneider, Buehn & Montenegro, 2010:443-461).

Smaller informal economies exist in nations with reduced compliance cost, lower tax rates, fewer legislations and bribery; nations where the rule of law is respected and upheld, and tax revenue funded (Schneider *et al*., 2010:443-461).

2.4 Informal sector perceptions

Activity of informal companies are beneficial on the economy and public value.

Informal businesses largely perceive taxation as a hindrance to their growth in an already hostile business environment. A majority of these enterprises do not adhere to the tax requirements, citing unconducive business environment, corruption, unfair treatment and provision of public goods and services of poor quality and quantity (Kireenko & Nevzorova, 2015:560-574).

2.4.1 Informal sector perceptions on public value

There has been no exhaustive conclusion on the effect of the informal sector on quality of life from prior research (Kireenko & Nevzorova, 2015:560).

Informal sector has both beneficial and negative effects on the economy and public value. For example, by raising total revenue through informal sector taxation, it positively impacts the standard of living. However, tax non-compliance by informal sector firms negatively affects welfare (Kireenko &

Nevzorova, 2015:560). Taxpayers who are more satisfied with their governments are more likely to continue to meet their tax obligations (Ali *et al*., 2014:829).

In developing nations where low levels of corruption and higher taxes lead in high-quality public services and products, companies in the informal sector are opting for the formal sector. A majority of companies are encouraged to enter the formal economy even when competitive pressure rises as they have faith in their governments to provide economic growth and survival environments (Corbacho, Cibils & Lora, 2013:79).

Governments must emphasize taxation in order to provide infrastructure, encourage growth and welfare and satisfy the ever-expanding requirements of people, as it is their main source of income. Income tax is the backbone of most of the world's tax systems. It is the largest source of revenue in most countries and a major agent for redistribution of wealth (Corbacho *et al*., 2013:79).

In most countries around the globe, personal income is an important pillar of revenue generation due to its ability to increase revenue. It is estimated that personal income earned in 2012 contributed 8.4% to developed countries ' GDP, whereas personal income in developing nations produced 1.4% of GDP (Corbacho *et al*., 2013:115).

In a country's search for efficient revenue collection for use in meeting public requirements, tax systems are basic instruments. Government-generated revenue helps provide social facilities, safety, and a politically and economically conducive climate in general. Taxation is also used as a means of redistribution of wealth in society (Akintoye & Tashie, 2013:224).

In other cases, taxation has been used as a regulatory instrument to encourage or prevent certain company trends that threaten citizens ' well-being. This approach could affect the informal enterprises ' perception of government intention positively or negatively. Tax morale does not always rise when government introduces tax laws to satisfy business and individual requirements. The tax morale sometimes reduces when participants consider the laws to be politically instigated in favour of the formal sector (Schneider & Buehn, 2012:4).

Government funds infrastructure construction to open up markets that lead to economic growth for trade effectiveness. A favourable environment for innovation and capital formation is also provided by the government. In addition, as government grows bigger, programmes for social welfare and wealth redistribution are at the top of the agenda. These programmes require greater taxation levels, hence law of diminishing returns (Vedder, 2001:1).

The state utilises tax funds to enact legislation and regulations to protect individual property rights and protect people from losing their profits to theft and foreign intruders. If the business climate is secure for trade, companies are responsive to government (Vedder, 2001:1).

Taxation is a policy tool used to achieve both government's social and economic goals. Most developing countries have additional fiscal and public policy goals. There are five goals of public income tax collection to communicate to all taxpayers; to gain financial authority for resource allocation, social development, financial stability, market control, and financial growth (Kayaga, 2007:6-7).

Most informal sector firms focus on creating revenue on their own and maintaining revenue for further investment. In these instances, the primary aim of business in society, which is essentially the preservation and growth of human capital and well-being, is overlooked by informal companies (Kireenko & Nevzorova, 2015:560).

Taxation does not always ensure that people are provided with public goods and services. Governments have varied and significant demands that are all based on scarce resources. Tax payment, however, is a shared responsibility of the government and all its citizens. To achieve the valuable products and services, each industry must assume its duty (Mutua, 2012:9).

Environment conducive to businesses in the informal sector is the result of government creating public value (Tanzi, 2001:10-17).

2.4.2 Informal sector perceptions of income tax

Sometimes the shadow economy is regarded worthwhile by suggesting that the industry promotes a country's financial and social equilibrium. This perception may be misleading as it disregards criminal financial behaviours in the informal sector such as tax evasion. As a means of survival in the very volatile and hostile environment, the informal sector justifies tax evasion, among other financial offences (Kireenko & Nevzorova, 2015:560).

Savings translates into financial strength and investment affordability. The more savings, the higher the investment chance and the greater the development of the economy. However, taxation decreases the quantity of savings in the economy (Akintoye & Tashie, 2013:224). High taxation will jeopardize economic growth. Taxation decreases disposable income which would normally be the source of investment in capital (Vedder, 2001:2). Informal companies therefore view taxation as an obstacle to their future investment plans and successful development.

Informal sector tax evading companies cited the pressure for survival caused by high tax rates, complicated legislation, elevated payroll taxes and labour costs (Capasso & Jappelli 2013:167).

Informal economy enterprises can afford to acquire cheaper labour by avoiding payroll taxes, thereby lowering costs relative to formal sector. Therefore, informal businesses can pass on cost savings from inexpensive labour to customers by providing products and services at reduced rates. The strong rivalry in formal enterprises leads them to work in the informal economy or to risk being kicked out of business (Cule & Fulton, 2009:820).

The perception of the informal sector in an economy characterized by poor governance of tax collection schemes, is that the tax system is corrupt, unfair and biased. This promotes low tax morale due to tax authorities ' unscrupulous functioning. The contention is hardly the cost of taxes, but tax evasion is increased as informal businesses recognize the tax authorities' corruption and unequal administration operations (Fulton & Cule, 2009:820).

Taxpayers will inevitably view the authority as reputable when tax officials have a strong reputation and are hired on merit. In such a situation, taxpayers are confident of the ability of the tax authority to efficiently implement tax laws and policies (Cule & Fulton, 2009:820).

Poor performance and inability to deliver quality public goods and services in government organisations decrease business incentives to disclose and contribute their income (Capasso & Jappelli, 2013:168).

Lack of democratic participation, low tax morale and institutional distrust also enhance the informal economy's size. If government fails to deliver the products and services requested by citizens, the democratic participation of the citizen will be impaired. It is essential that governments exhibit efficiency in order to motivate companies and individuals to fulfill their tax obligations (Capasso & Jappelli, 2013:168).

The entrepreneur in the informal economy can evade tax responsibilities, which prevent access to credit markets. These entrepreneurs are therefore forced to use own wealth for capital formation. Informal enterprises are also more labour intensive compared to their low levels of production. In the formal sector, the businesses have some degree of access to credit markets and must pay taxes. Other disincentives for tax adherence, as mentioned above, are arbitrary and complex tax regulations, policies and processes (Capasso & Jappelli, 2013:168).

Governments in low-income countries are pushing companies into the informal sector by increasing formalisation associated costs. These obstacles are a barrier to private-sector dynamism as they undermine entrepreneurship. The emergence of informal business represents an escape by informal enterprises from formal status. This is because of bureaucracy and exorbitant formalisation costs. The informal sector furthermore resists formalisation and taxation because of perceived corruption and dysfunction of the state. However, tax evasion by the informal economy may also stifle entrepreneurship, as firms sometimes deliberately remain small to avoid regulators (Woodruff, 2013:2-12).

Tax non-compliance in this sector is an outcome of a cost-benefit decision. The benefits are defined by the taxes that can be avoided and costs are represented by governmental deterrence measures and the probability of being penalised (Schneider *et al*., 2010:443-461).

2.5 Weaknesses in tax management

Admittedly, tax non-compliance in the informal sector is very high compared to formal sector companies that are much more visible to agents of KRA. Not only through taxpayers' behaviour and inaction, but also through tax administrators, non-compliance arises (Ofori, 2009:40).

Compliance with and non-compliance with tax commitments is a consequence of political, legal and administrative actors ' choices as well as taxpayers ' behaviour. This suggests that tax non-compliance is not just the taxpayer's function, but also tax administrators’ responsibility (Ofori, 2009:40).

A focus on the tax non-compliance behaviour of informal sector enterprises is critical when studying weaknesses in tax management. This section advances the typology of non-compliance hypothesis of Kidder and Craig (Kidder & Craig, 1989:21-34).

The variables of non-compliance are discussed below:

Procedural non-compliance results from non-compliance due to tedious and elaborate tax payment processes. When compliance with laws and processes is time-consuming and resource-consuming, only a few informal entrepreneurs are prepared to comply (Kidder & Craig, 1989:21-34).

The following Figure 2 provides an example for procedural non-compliance.

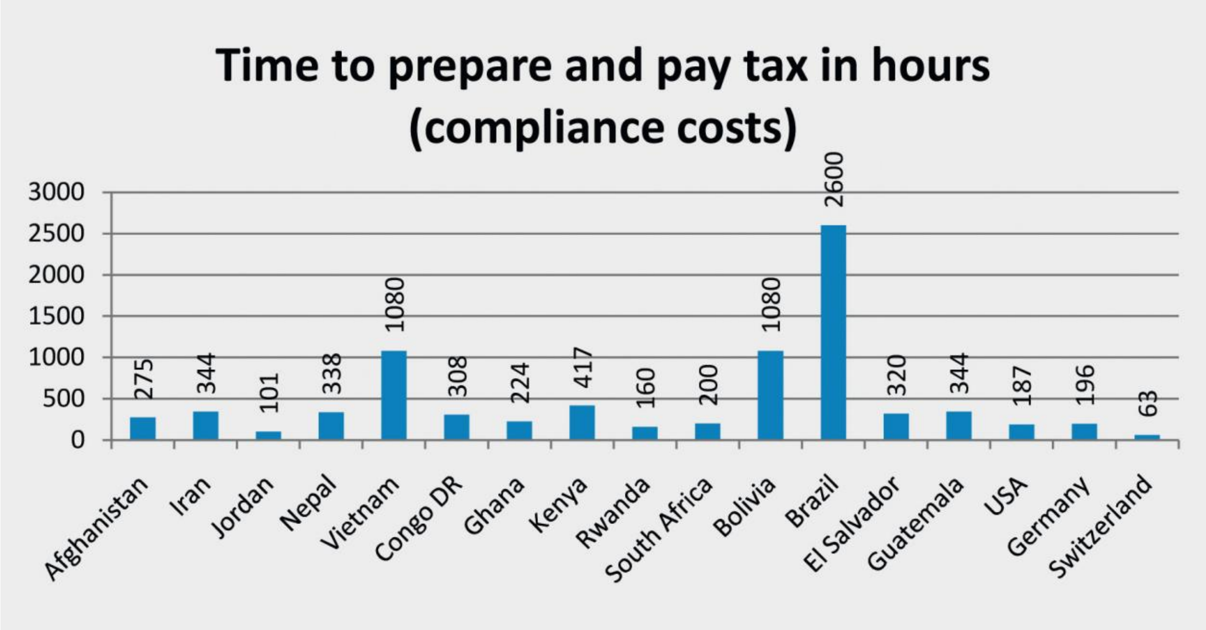


Figure 2.1 Time to prepare and pay tax in hours

Source: The World Bank, World Development Indicator 'Time to prepare and pay tax in hours', 2008

In 2008, the World Bank created an indicator of global development as a "time to prepare and pay taxes" metric. It has produced diverse outcomes for various nations. For example, tax preparation and payment in high-income Organisation for Economic Cooperation and Development (OECD) countries required an average of 210 hours (Siehl, 2010:15).

Kenya takes the longest time compared to the other sub-Saharan African nations; preparing and paying taxes in Kenya requires 417 hours. In South Africa (200 hours), Ghana (224 hours), DRC Congo (308 hours) and in Rwanda (160 hours). Taxpayers are also unwilling to participate in the tedious and time-consuming tax process if the administrative burden is very significant. For instance, Yemen has 1,500 separate taxes, licenses and charges at distinct prices covering multiple bases. Compliance costs are likely to be exorbitant, resulting in exceptionally minimal likelihood of compliance (Siehl, 2010:15).

Small to medium-sized businesses are suffering the most from high expenses of compliance. A study undertaken in South Africa disclosed that a deterrent to tax compliance is the paperwork that needs to be mastered in order to meet tax demands. Approximately 18 percent of surveyed participants stated that they prefer to avoid or evade tax rather than cope with elaborate documentation and bureaucracy (Siehl, 2010:15).

Ignorant non-compliance includes tax underpayment due to ignorance of complicated, varying and sometimes ambiguous tax schemes. There have been a number of modifications in Kenya, for example, since the Income Tax Act was enacted in 1973 owing to modifications in state fiscal planning (Income Tax Act). Volatile and frequent changes in tax legislation leads taxpayers and tax officials to confusion, resulting to tax evasion. Ignorance of the diverse complexities in tax systems complicate enlightenment and compliance (Kidder & Craig, 1989:21-34). Hiring qualified, competent and motivated tax officers as well as periodic training is critical in achieving tax compliance (Siehl, 2010:17-18).

Lazy non-compliance occurs when individuals are lazy in the areas of documentation, record keeping of their business transactions, hence non-compliance (Kidder & Craig, 1989:21-34). It is therefore important for the tax authority to be vigilant and enforce tax compliance. Empirical studies propose that people inherently comply with tax requirements when they sense a high level of scrutiny by the tax authorities to avoid penalties and severe legal action (Siehl, 2010:14-15).

Asocial non-compliance happens when taxpayers position their companies in ways that are undetectable. These include the use of cash transactions and frequent relocation to prevent attracting the taxman's attention (Kidder & Craig, 1989:21-34). This can also happen when there are loopholes within the tax system promoting tax avoidance (Siehl, 2010:9). Some have defined tax avoidance as a legal means to reduce tax liability. As much as tax avoidance may seem legal, it goes against the spirit of patriotism and is undesirable (Fuest & Riedel, 2009:5).

Symbolic non-compliance occurs when there is a protest against perceived injustice and inequities in tax legislation. This means refusing to pay tax as a protest against what is perceived as unfair tax legislation and abuse of tax revenue (Kidder & Craig, 1989:21-34). The taxpayer's morale is affected by a sense of fairness and equity in the tax scheme. Taxpayers are unwilling to pay taxes when there is low quality or absence of service in exchange for taxes paid. When the tax system is unfair or with no accountability and transparency tax non-compliance in inevitable. This usually occurs in a weak fiscal jurisdiction and a corrupt legal system (Siehl, 2010:14-17).

Social non-compliance is due to peer pressure and social influence among taxpayers. This occurs when a social network of individuals jointly refuses to pay taxes, citing bribery and corruption. Society protests because exorbitant tax rates do not result to personal gains (Kidder & Craig, 1989:21-34). Tax morale is not simple to implement; it is particularly hard in nations lacking an inherent culture of tax liability (Siehl, 2010:17).

Brokered noncompliance takes place upon the advice of a knowledgeable expert such as a financial advisor, or a lawyer. The taxpayer is instructed on smart ways to avoid taxes and the resulting tax savings are then shared between the businessman and the expert. This can be mitigated if tax authorities offer tax incentives to encourage full disclosure (Kidder & Craig, 1989:21-34).

Habitual noncompliance arises over time when the taxpayer sets a habit of non-reporting of business transactions. This mostly occurs in an environment where there is low tax morale because the tax authority is perceived to exercise more 'policing' than 'administrating' (Kidder & Craig, 1989:21-34).

2.6 Improving tax efficiency

There is no single answer within the informal industry to the issue of tax avoidance and evasion. The strategy to curbing this issue will rely on the distinctive structure of a country's tax policy. An efficient strategy is a country-specific strategy that is sensitive to tax avoidance and/or evasion triggers. The absorptive capacity is the rate at which people are responsive and receptive to interventions and/or changes instituted by government. Policymakers need to consider the absorptive capacity of the country when developing policies for tax reforms. Low absorptive capacity requires less ambitious policies for reforms, otherwise the effort will be a total failure. However, if the absorptive capacity is high, reforms are successfully embraced by citizens (Siehl, 2010:25).

2.6.1 Tax administration

Tax collection in Latin America and the Caribbean has risen by 30% over the past two centuries as a consequence of administrative changes.
Currently, tax administrators have realised budgetary and technical independence in most nations. Tax authorities have skilled information and communications technology (ICT) employees, consequently, by means of technology, the role of tax collection is underscored with higher focus on all potential taxpayers (Corbacho *et al*., 2013:99).

It is of paramount significance that tax officials design a streamlined system to improve the collection of revenue from informal sector tax. In relation to simplifying the scheme, it is recommended that the characteristics of the informal sector be taken into consideration in the design of tax systems. Redundant bureaucracy should be removed from the process of tax administration by offering all tax-related facilities in a one-stop-shop type setting (Moyi & Ronge, 2006:29).

Having autonomy from influences from other governmental arms certainly affects tax agency tax collection effectiveness (Corbacho *et al*., 2013:99). The independence of the tax authority is critical to achieving effectiveness in the identification of tax liabilities, collection and prosecution of tax evaders. However, autonomy limits exist. The tax authority needs some political legitimacy and complete control of appropriate funds in order to exercise autonomy. It is probable that an independent tax authority will show excellent efficiency as it has a chance for efficient management procedures. However, autonomy is not a guarantee that the informal sector will meet tax obligation (Fjeldstad & Rakner, 2003:17-18).

Also important are economic, social and political considerations beyond the control of the tax authority. This is an essential factor when dealing with the informal economy for tax administrators (Fjeldstad & Rakner, 2003:17-18).

2.6.2 Tax policies

Within each of the main tax categories, which include personal and corporate income, some redesigning is required to enable efficiency in collection. Levying of the taxes should be spread to a wider tax base and possibly at a lower rate, while at the same time shrinking tax reliefs unless directed at addressing serious economic threats (OECD, 2010:1-2).

Member States of the European Union (EU) review their tax policies on a regular basis with a view to improving tax policy designs in order to achieve budget surplus; job creation; economic growth; and fairness. In recent years, EU Member States have increased the general tax burden, albeit with reduced labour taxes on low-income earners.

Passive income earners had a higher tax burden. Most countries have decreased tax relief and allowances. Taxes linked to consumption and the environment were also improved, although the impact of environmental taxation on the budget was very minimal. Member States relying on mortgage interest payments altered their schemes and removed the reliefs. Financing the relief of low-income earners became particularly costly and required re-examination of current policies to identify revenue-enhancing strategies without putting government resources at risk. Sustainable alternatives can be quite restricted in terms of tax relief for low-income earners. Lower income taxes can be either offset by raising other sources of income or by cutting government spending (European Commission, 2014:1-25).

To enhance tax adherence, all EU nations focus on combating tax evasion and fraud. Measures have therefore been and are being instituted on an ongoing reform to achieve these goals. As of 2014, the tax burden in the EU was comparatively high, so member countries deemed attempts to decrease the burden on low earners a move in the correct direction (European Commission, 2014:15-25).

2.6.3 Outsourcing revenue collection function

For the past 19 years, Mozambique has regularly subcontracted the private corporation "Crown Agents" to handle income collection on behalf of government. The country's income had risen by 40% within the first year. The agreement was intended to be a temporary one with the subcontracted company. By subcontracting Crown Agents, the government's purpose was to decrease corruption and streamline the process of tax collection, but outsourcing turned out to be costlier and not less prone to corruption in the longer term (Fjeldstad & Rakner, 2003:17-20).

2.6.4 Salaries and wages

Low wages and/or salaries can translate to low levels of staff motivation. However, in some instances, the tax system continues to flourish regardless of comparatively low wages, bribery and mismanagement. Wages and incentives are just one element that affects tax officers ' behaviour. In addition to competitive pay, internal control processes and staff behaviour, policies are essential in maintaining high integrity (Fjeldstad & Rakner, 2003:19)

2.6.5 Cost benefit analysis

Compliance cost affects and determines informal business tax adherence. Compliance costs may include, but are not limited to, bookkeeping, cost of auditors for audited financial statements and postal costs. A majority of informal activities remain informal due to the high cost of compliance associated with formalisation, exacerbating tax evasion. PricewaterhouseCoopers and the World Bank revealed increased expenses of tax compliance in Bulgaria and the Czech Republic in 2013. In their successive tax reforms, these two nations eventually integrated the feedback and observed important income gains (European Commission, 2014:107).

2.6.6 Equity and efficiency

Tax reforms involve extensive consideration of variables related to equity and efficiency. The tax benefit schemes in the EU nations in 2012 resulted in most countries experiencing market inequality. Increased personal income tax and tax base expansion among other reforms led in lower income inequality in many EU Member States. Voluntary compliance with taxes is a government concern. Therefore, when tax revenue officials make tax policy changes, they should prioritize taxpayers ' cost efficiency. The cost of taxpayer compliance with the tax liability should not be a deterrent to compliance (Siehl, 2010:26).

A majority of nations have embraced progressive tax systems to further decrease income inequality. A progressive tax is a tax that increases the tax rate as the taxable amount increases. The tax burden corresponds directly to the rate of revenue earned If the tax base is expanded, the progressive taxation approach is fair and efficient (European Commission, 2014:107).

2.6.7 Legal system

The legal framework for enforcing tax demands is a critical perquisite. Tax regulations are quite unstable in developing nations. Frequent modifications lead to confusion for both taxpayers and tax administrators. The outcome is tax avoidance and evasion. The situation is aggravated further if there are rapid and frequent changes in tax laws (Siehl, 2010:17-18).

2.7 Summary and deductions

The question of whether informal economy taxation is justified has been the topic of debate for many years. Critics suggest that informal sector taxation produces minimal revenue compared to steep administrative costs and corruption associated with revenue collection from the sector. The proponents of taxing the informal economy advance that such taxation is critical in sustaining tax compliance and tax morale among other tax payers. There is some proof that formalisation can lead to development and greater profitability for informal enterprises. In addition, the informal sector's tax compliance will offer these companies moral authority to engage with the government on legitimacy, good governance, and political accountability issues. Recent study has highlighted that informal sector taxation can bring long-term and important advantages to the public value. It is suggested that taxation of informal enterprises will – ceterus paribus – result in increased revenue, economic growth and quality governance. It would also be an imperative catalyst for expanding political voice among the citizens, mobilisation and public accountability.

In turn, tax avoidance by the informal sector can decrease the quality and amount of public goods and services. Small-scale activities, cash transactions and lack of record-keeping are the main factors why taxation in sub-Saharan African countries is challenging. Informal companies in South Africa, Kenya, Tanzania, and Uganda do not meet tax obligations because they perceive the goods and services provided by governments as of poor quality, with little in enhancing public value.

These nations have strict laws on tax violation, but due to high-level corruption, no action is ever taken against non-adherence behaviour.

Tax compliance is not the onus of taxpayers only, but a responsibility shared with tax administrations and other state agencies. Tax noncompliance can be the result of political and legal issues, among other administrative factors, as proposed by Kidder and Craig in their theory of typology of noncompliance.

An efficient strategy to curbing the informal sector's tax evasion issue would be one that is country-specific and one that considers the absorptive capacity of each country.

Taxation is an instrument for redistribution of wealth, social development, financial stability, and economic growth. However, informal sector sometimes perceives taxation as a plan to hinder growth because of observed corruption, and biased treatment by tax administrators. Taxation is also used as a regulatory tool to discourage certain companies that are compromising citizens well-being. A majority of people cooperate and adhere to tax requirements if they have faith in their governments to provide environments conducive to business growth and survival. Although, the informal sector, mainly being in small businesses, sometimes finds tax evasion as the only way to survive in highly volatile, expensive, and hostile business environments. However, tax evasion by these businesses is also a negative approach as it may stifle entrepreneurship and innovation because these firms remain in the shadows to avoid detection by tax authorities.

Despite the KRA's attempts, challenges that remain have slowed the accomplishment of the completely integrated and modern tax scheme needed to boost income generation. Among the five existing taxation options, turnover tax is perhaps the best attempt so far to bring change in generating revenue from informal enterprises in Kenya. Technology is a significant contributor in improving revenue collections and expanding tax nets. Automation and integration of tax systems with other relevant online systems will mitigate evasion by sealing all the loopholes associated with tax noncompliance.

Chapter 3 presents characteristics and delimitations of the tax system in Kenya.

Chapter 3: Characteristics and delimitations of the Kenyan tax system

3.1 Introduction

This third chapter unpacks Kenya’s tax incidences, legislation and policy imperatives, and the variations in taxpayer compliance. The section offers a wide overview of Kenya's tax system, the reforms that have occurred over the previous decades, and the current administrative structure. Since tax management is vital to taxation, it is important to investigate whether a method that can be recognized and measured follows its reform.

The overall goal is to identify the lessons needed to model an appropriate and sustainable tax reform policy in Kenya and, ultimately, to suggest reform steps to model a strategy for sustainable tax management in Kenya. The critical part of this chapter involves the assessment of tax incidence and variations in tax reforms within different jurisdictions in order to determine a composite of feasible reforms to help expand tax base of informal sector in Kenya amidst economic, social and political challenges.

3.2 Tax incidence in Kenya’s informal sector

In theory, the incentive of a taxpayer to comply with a tax scheme relies on an evaluation of the comparative advantages and related compliance costs vis-à-vis non-compliance. According to a report by the Institute of Economic Affairs analysing the Finance Bill 2018, one of the profound reasons why the players in the informal sector in Kenya were unwilling to remit taxes to the authorities is the general perception that the tax burden was too high. This fundamentally presents a significant challenge for KRA to create efficient processes to improve a tax compliance stance (Mpapale, 2014:6-8).

From the outset, it must be clear that the sole objective of an efficient tax regime in the context of the informal sector is aimed at extending the tax net to a factor, however negligible. As the informal sector contributes to public coffers; it is not intended to suppress their growth or disproportionately burden them.

Advancing legal and administrative tax reforms in the informal sector is by no means a policy directed at stifling development or the very presence of informal businesses. On the contrary, these reforms are intended to unlock the sector's full potential and gradually transform it from informal to formal. We may have a stronger understanding of the need to expand the tax base by analysing the implications of a weak informal sector tax system in Kenya.

3.2.1 Kenya Revenue Authority and informal sector taxation

Kenya's informal sector is too large to be ignored. There is a critical need to harness much-needed government revenue by taxing this very vibrant informal industry. The tax revenue gap is defined as the difference between potential tax income and actual tax income within an optimal environment. Measuring the tax gap is difficult, but numerous reforms have been implemented to improve tax collection and administration in order to improve the Kenyan tax base. However, the remaining difficulties have slowed the accomplishment of a completely integrated and modern tax scheme needed to boost income generation (Mpapale, 2014:6-8).

Kenya recorded an annual GDP of 1.68 trillion KShs in 2013, a 4 percent rise over 2012 as reported by the Kenya National Statistics Bureau (KNBS). Despite this trend, Kenya frequently suffers national budget revenue deficits. The state had a budget deficit of 4.8% of GDP in 2013. In 2019 there was still a budget deficit of 6.2% of gross domestic product (AF, 2020).

The government through KRA has deliberately tried to reform the tax system to make it more responsive and effective in coping with tax evasion through transfer pricing and black economy activities (Mpapale, 2014:6-8).

In 2012, KNBS ' financial study revealed that about 8.3 million individuals were employed by the informal economy. This translated to 75% of the labour force in the country. The informal sector also accounted for 25% of the domestic GDP. More than 60 percent of the workers in the informal sector are aged between 18 and 35 years, with half of them being women. The informal sector reveals exponential expansion because of deregulation that has resulted in ease of entry and exit in the sector (Mpapale, 2014:6-8).

Formal job opportunities are scarce to the extent that even extremely trained individuals resort to the informal economy. In addition, capital formation to start formal business is an extreme stretch for most Kenyans. There is also a significant population of unskilled workforce making formal jobs even more hazier for most individuals (Mpapale, 2014:6-8).

The primary reason Kenya's informal sector is unwilling to fulfill tax commitments is due to the perception of exorbitant tax burden. The incentive for taxpayers to comply with the tax requirement is determined by their evaluation of the benefits against compliance costs. This underlines that the predicament of tax evasion can no longer be restricted to technical and financial variables, but to taxation components of human perception. In the early 1990s, the informal sector's prospective revenue was approximately 4 percent of GDP on average. The tax authority had the chance to boost the sector's income by an amount equal to 4% of GDP. Kenya's GDP was estimated at KShs 1.68 trillion in 2013; 4% percent of that is estimated KShs 67.2 billion. This amount if paid by the informal sector in 2013, the tax base would have been enhanced (Mpapale, 2014:10).

The rigid tax policies and laws regulating the formal sector while leaving the informal sector unregulated give the informal economy an undue benefit. If authorities were to ensure equal and fair treatment, for example by ensuring that all informal companies are registered for VAT, the market would be levelled and competitive for both formal and informal companies. Tax justice would be achieved if the revenue authority taxed both the income of informal and formal staff. In addition to maximising income, there are other overwhelming reasons why the KRA should seek to control the informal sector in order to guarantee compliance (Mpapale, 2014:10).

It is estimated that KRA will lose 300 billion KShs worth of prospective income from the informal sector annually. Income tax is regulated by the authority's provisions of the PAYE rules. PAYE is the tax tariff that employers are needed to collect and pay in advance by deducting earnings from staff wages (Masinde & Mwangi, 2010:14).

By using a reference number known as the PIN, KRA recognizes taxpayers. Majority of informal sector organisations in Kenya are not registered by KRA; therefore, there is no reference for their companies within tax system. It is becoming increasingly hard to tax personal income effectively (Masinde & Mwangi, 2010:14).

The launch of the Revenue Administration Reform and Modernization Programme projects has implemented a way to address tax problems. It was a result of the KRA Second Corporate Plan (2003/04–2005/06) and set the stage for the injection of momentum to consolidate the profits produced in tax administration.

KRA made incremental steps towards transforming itself into a contemporary, completely integrated and customer-focused organisation during the era of the Third Corporate Plan (2006/07–2008/09).

KRA Fourth Corporate Plan (2009/10–2011/12) and the Fifth Corporate Plan (2012/13–2014/15) have developed and implemented further reforms. The Sixth Corporate Plan (2015/16–2017/18) was intended for building taxpayer trust through improved taxpayer compliance facilitation.

KRA introduced the iTax, a web-based system directed at improving national tax administration and providing services including electronic taxpayer registration, electronic filing and payment. Regional support centres for KRA iTax were also established in some of the cities like Nairobi, Mombasa, Kisumu, Nyeri and Eldoret (Revenue.go.ke, 2016).

KRA also introduced a culture change programme to promote continuing attempts to modernize. The goal is to help develop fresh cultures, attitudes and behaviours by concentrating on the' individuals ' aspect of change, as well as reinforcing environmental issues influencing employees (Revenue.go.ke, 2016).

The tax base in Kenya still has enormous potential for growth in the informal sector despite present efforts to seal income leaks. Kenya's tax structure was intended to depend on corporate tax; pay as you earn; withholding tax; and value-added tax as the main instruments of tax. The efficacy of these tax heads in the informal sector is investigated (Mpapale, 2014:12).

3.2.1.1 Corporate tax

The provisions of the Income Tax Act, cap 470 of Kenya's legislation, govern this. Both resident and non-resident businesses are subject to corporate tax. All resident businesses are taxed at a rate of 30% of their taxable revenue (Mpapale, 12:2014).

Corporate tax efficiency

Corporate tax as a strategy for collecting income tax has absolutely no impact on the informal economy's company operations. This is because the tax instrument was intended to cover formal institutions with a properly specified management and reporting framework. Because the tax rate applies to a corporate's taxable income, as per independently audited books of account. The informal sector lacks audited books due to required expertise and related expenses (Mpapale, 12:2014).

3.2.1.2 Pay As You Earn

PAYE is generally a tax scheme for the employer, under which a tax corresponding to the employee's remunerations is deducted and transferred by employer to KRA. PAYE tax incidence are borne by employees. In cases of default, employers are subject to penalties and tax amount is collected from them in cases where the employee is not complying with PAYE legislation (Mpapale, 12:2014).

The third plan of the ITA describes the (graduate scale) tax ranges for which tax rate is computed.

Table 2.1 Pay as you earn annual bands

Income bands	Rate in each shilling
On the first KShs121,968	10%
On the next KShs114,912	15%
On the next KShs114,912	20%
On the next KShs114,912	25%
On all income in KShs466,704	30%

Source: Paragraph 3, third schedule ITA cap 470 of the laws of Kenya

PAYE tax efficiency

KRA uses a unique identifier -PIN- to distinguish registered taxpayers. It is increasingly difficult to efficiently tax personal income in the informal sector being that they are not in possession of PINs. PAYE strategy has not brought informal economy participants into the tax net insofar as it only recognizes employees and employers in the formal sector (Mpapale, 13:2014).

3.2.1.3 Value added tax

VAT is a tax on consumer goods provided or consumed in Kenya. The VAT Act in Kenya has experienced major reforms (Value Added Tax Act). The VAT Act cap 476 was a piece of law which led to significant income leaks due to continuous changes and implementation of supplementary laws and legal notices over time. In 2013, the VAT Act 2013 was eventually enacted with more precise and fair laws. Sadly, this simplification method has led to a rise in the tax burden on the public by taxing household goods (Mpapale, 2014:13).

VAT efficiency

Value Added Tax is largely inoperable as a tax system in the informal industry. This mechanism is highly formal, requiring that suppliers of ‘vatable’ goods and services be formally registered and issued with VAT certificate. Due to informality, this is extremely hard to accomplish. Finally, VAT Act minimum limit for enrolment, an average annual turnover of KShs 5 million, lock out the bulk of the informal sector's taxpayers far below this limit (Mpapale, 2014:14).

3.2.1.4 Withholding tax

Withholding tax (WHT) is a way of paying taxes by the payer of income rather than the recipient of the income to the government. The tax is therefore withheld or deducted from the receiver's income (Mpapale, 2014:14-15).

Withholding tax efficiency

While many of the institutions in the informal sector usually obtain withholding-tax facilities, they cannot deduct this, because they are not registered within the KRA system (Mpapale, 2014:14-15).

3.2.1.5 Turnover tax

Presumptive taxes refer to the use of simplified and cost-effective methods for taxing companies and individuals that often evade tax, often by non-reporting or under-reporting of actual income (Tadesse & Taube, 1996:2-5).

Standard assessments are presumptive tax schemes in which a fixed lump-sum tax is levied on taxpayers on the basis of the occupation or business activity in which they are engaged (Tadesse & Taube, 1996:6-12). Estimated assessments are presumptive taxes that depend on the tax authority 's estimation of the profits of the taxpayer; they are especially applicable to the taxation of commercial activities for which understatement of profit is persistent and pervasive (Tadesse & Taube, 1996:6-12).

A presumptive tax regime can mean firms pay substantially lower tax rates than under the standard regime. This can reduce revenue and augment informality (Rao, 2014:20).

Presumptive taxes are usually preferred for their administrative simplicity and economic efficiency. In Zimbabwe, informal sector presumptive personal income taxes (PIT) are horizontally inequitable compared with formal sector PIT. This is due to the rates built into the PIT system, whereas presumptive taxes are either lump sum or proportional turnover taxes. However, presumptive taxes are fairer compared with company income tax (Dube, 2014:48-62).

Zambia and Tanzania use turnover tax regime to tax the informal sector. However, unlike Zambia, Tanzania has progressive turnover tax system and its upper threshold is significantly lower. The presumptive tax has shown some gains in revenue generation from informal sector, nevertheless, the administrative costs associated with collection IN Zambia are very high (Taxation of the informal sector, 2018:4-5).

The Financial Act 2006 implemented Turnover Tax (TOT). The TOT may be the greatest effort to generate revenue from informal sector in Kenya so far (Finance Act).

TOT is for any business activity with a turnover of KShs 500,000, but does not exceed KShs 5 million for any year's revenue. TOT covers all businesses, professions, and any profitable activity. Therefore, nearly every activity of the informal economy is subsequently taxable. In Kenya the tax rate applied to TOT is 3% of company's annual revenues. In comparison to other tax instruments the extent of record keeping required under the TOT regime is significantly simplified (Mpapale, 2014:14-20).

TOT efficiency

The most significant advantage of turnover tax is that it provides a much more streamlined system for taxing the informal sector. Any extra administrative costs are prohibited because TOT guarantees streamlined tax computation that only depends on turnover sales (Mpapale, 2014:14-20).

3.3 Kenya's tax legislation and reforms

In August 2010 following the enactment of the New Constitution of Kenya, the system of taxation represents the two-tier state structure-national and county governments. The national governments delegates to the regional counties certain fiscal powers and duties (Mutua, 2012:11-14).

Under Article 209 of the 2010 Kenya Constitution, both the central and the county governments have authority to impose tariffs or increase revenue. The allocation of revenue accountability between the two levels of government is in accordance with the devolution structure. The structure guarantees that the national government is responsible for transactions with substantial tax grounds. The national government is responsible in particular for the collection of income tax, VAT, custom duties and excise taxes. The government must be able to redistribute national resources and stabilise the economy as the key tax system objectives. Article 209(3) authorizes the county governments to impose property taxes, entertainment tax and any other tax. Moreover, county councils can charge local-level levies (Mutua, 2012:14-20).

Kenya's tax law is legally binding. The main tax laws in Kenya are provided for in Kenya's Constitution, Parliamentary Acts, and the different Financial Acts adopted each year. Article 210(1) of the Kenyan Constitution, 2010, stipulates that, except as allowed for by law, no tax or licenses may be implemented or revoked. The principal tax legislation comprises the Income Tax Act, Value Added Tax Act and the Customs and Excise Act. The statutes pertaining to the county tax include the Entertainment Tax Act, among others, which require extensive changes in order to be effective for the counties (Gichuki, 2015:6-12).

Kenya's government embraced the 1986 Tax Modernisation Programme and t he 1987 Budget Rationalization Programme. This was based on the 1986 Session Paper No. 1 on Economic Management for Renewed Growth. This was initially designed in the African Socialism Session Paper No. 10 from 1965 and applied to planning in Kenya. The Modernization programme aimed to increase the public income base, while rationalisation engaged rigid fiscal checks on spending. In particular, the Modernization Programme aimed to increase income and decrease implementation and administrative expenses by means of minimal and rationalised tax prices and broader tax bases. The aim of the programmes was also to improve taxation by eliminating leakages, increasing computer use and monitoring in an effort to improve the organisational ability to handle tax policies by developing efficient mechanisms of database management (Gichuki, 2015:8-18).

These targets were subsequently extended to include increasing the revenue-GDP percentage to 28 percent; reinforce the development of the emerging investment markets; stress self-assessment schemes; strengthen training and customer service for taxpayers (Gichuki, 2015:8-18).

In terms of administration and governance improvements, revenue collection has increased by approximately two percentage points of GDP between 2003 and 2004. Since then revenue collection has been maintained at around 21 percent of GDP, excluding the 2005/06 financial year, when it had not been achieved because of customs computerisation problems that resulted in reduced import duties and VAT on imports (Gichuki, 2015:8-18).

In 2006/07, revenue was projected to rise from 20.7% to 22% by 2015, and maintaining that level until 2030. It could result in a substantial tax liability, unless more people are included in the tax base.

The Kenya Vision 2030 does not, however, provide for particular policies to sustain a strong tax drive. In order to monitor and make suitable suggestions to reform the tax scheme for easy accomplishment of Vision 2030 the government formed a Tax Harmonisation Task Force. The fiscal gap is a significant key to establishing the overall reform approach. No extensive research and evaluation of the tax gap in Kenya had been performed prior to the multiple tax management changes in Kenya. The overall strategy to the revision therefore fails to comply with the fundamental principles. There are also indications of inconsistency in fiscal reform policies. This shows a haphazard approach without a fundamental layout. While the 1986 Tax Modernization Programme sought to increase the tax revenue-GDP ratio from 22% in 1986 to 24% by the mid-1990s and subsequently to 28%, Kenya's vision 2030 aims to increase from 20.7% by 2006/07 to 22% by 2015 and to maintain the revenue-GDP ratio by 2030(Gichuki, 2015:8-18).

In Kenya, it takes longer than neighbouring countries to meet tax requirements. For a firm in Kenya, 417 hours is required, much longer than Burundi, Uganda, Rwanda and Tanzania, to calculate and pay all required taxes. The average global time is 286 hours. This leads to the problems of the tax system (Gichuki, 2015:8-18).

Many tax administration reforms have been introduced since independence, including;

3.3.1 Personal Identification Number (PIN)

This was designed for proper identification and tracking of taxpayers. Every taxpayer should register and his / her individual PIN be assigned. The PIN is needed when filing income tax declarations and other tax returns. A solid taxpayer recognition scheme is essential to excellent tax management. This involves controls such as ensuring that no PIN is allocated to more than one taxpayer. The PIN is linked to the taxpayers' identity numbers as well as company registration numbers (Gichuki, 2015:8-18).

3.3.2 Centralised tax agency

In 1986, a tax reform agenda and the 1986 Session Paper No. 1 on Economic Management for Renewed Growth set the foundation of the development of KRA. Kenya Revenue Authority was created in 1995. This was in tandem with other sub-Saharan African countries which set up their own semi-autonomous revenue agencies. Amongst the latter are Ghana in 1985, Uganda in 1991, Zambia in 1994 and Malawi in 1995. The following countries have joined forces: Tanzania -1996, South Africa-1997, Rwanda-1998, Zimbabwe-2001, Ethiopia-

2002, Sierra Leone-2002, Lesotho-2003, the Gambia-2005, and Mauritius - 2005 (Gichuki, 2015:8-18).

3.3.5 Electronic Tax Register (ETR)

The ETR was implemented through public notices of 15 December 2004, mainly public notices nos. 48, 49, and 50. The ETR was introduced to improve VAT collection following studies in Italy, Greece and Turkey (Gichuki 2015:8-18).

3.3.6 Certificate of tax compliance

Everyone dealing with government offices is required to produce a certificate of tax compliance. This guarantees conformity. However, this will depend on the cooperation of other government agencies (Gichuki, 2015:8-18).

3.3.7 Turnover Tax

This was achieved by transferring taxpayers with sales below the 5-millon KShs annually from the VAT system to the turnover tax system, thereby simplifying their way of creating profits (Gichuki, 2015:8-18).

3.3.8 Integrated Tax Management System (ITMS)

This was one of the main programmes for 2009/10-2011/12 in the fourth KRA corporate plan. The goal was to ensure the full automation of all income departments. ITMS is based on the tax system in Chile (Gichuki, 2015:16-18).

From the multiple projects it is evident that the state is more engaged in the growth and implementation of tax administration systems. They include Electronic Tax Register (ETRs), Simba 2005 (S2005S) system, and PINs. These schemes have mostly been purchased from other countries. The S2005S originated in Senegal; the ITMS was purchased from Chile; as a consequence of research trips to Italy, ETR was a concept from Greece and Turkey (Gichuki, 2015:18-20).

These reforms experienced severe difficulties with their execution, both internally and externally. There is still a discussion on the level to which the PIN is applied to access public services. The impact of this is that there is a reduction of tax or an increase in tax collection costs (Gichuki, 2015:18-21). This issue is complicated by the reality that county governments eventually take over the predecessors ' structures and procedures, which were often dysfunctional (Gichuki, 2015:20-28).

3.4 Current challenges for tax policy reforms

The several tax administration reforms undertaken in Kenya do not exhibit a comprehensive strategy, theme, policy or methodology. There has been no clear, deliberate and integrated reform mechanism to avoid haphazard implementation of reforms. The fiscal reform approaches to be implemented have also been inconsistent. African countries face a series of challenges in terms of tax optimisation and development objectives. Perhaps the toughest task to overcome is to discover the ideal equilibrium between business-friendly taxation and capital while leveraging enough revenues for the provision of public services which, in turn, leaves countries more appealing to investors.

Total government revenues as a percentage of GDP have continuously risen in most African nations after an era of steady development between the mid-1990s and the mid-2000s. The amount of domestic revenue–identified as government income and non-tax profits excluding subsidies–rose between 2002 and 2007 by almost 4% of GDP, to an average of over 25% in 2007 for the whole of sub-Saharan Africa. Except for Nigeria and South Africa, government revenues as a share of GDP increased further across the continent from 18.8% for the years 1997/2002 to 25.4% in 2007 on average.

Nevertheless, the increased tax revenue in the region was significantly influenced by natural resource revenues. This included revenues from taxes on petroleum and mining businesses. Revenues associated with non-resource activities increased by less than 1% of GDP over 25 years. This is even more significant looking at the consequences of the crisis in Africa, where in 2009 economic growth was estimated to be only 2.8%, less than half of the estimated 5.7% in 2008 and a significant drop in export revenue and a slowdown in investment in oil and mineral products. In comparison with the OECD countries ' 36% tax-to-GDP ratio, African governments clearly have a large revenue gap (OECD, 2010:1-12).

3.4.1 Tax evasion

In 2008, a US senate issued a report highlighting that banks located in tax havens cost US taxpayers some USD 100 billion a year in lost revenue. Despite strong US legislation, agencies and other processes to prevent tax evasion, leakages have been reported. If such capital flight occurs in regulatory frameworks commonly perceived as sound, then many more opportunities exist for evasive practices in countries with weak regulatory and legal environments. For Kenya, tax evasion contributes more than just to the current economic crisis. Tax evasion is one of the main obstacles to increasing the fiscal base and mobilising domestic resources (Pfister, 2009:4-17). The KRA is estimated to lose potential revenue to the value of KShs 300 billion from the informal sector annually. Tax revenue collected in 2013 would have been improved by KShs 67.2 billion if the tax authority had been able to tax the informal sector (Mpapale, 2014:10).

3.4.2 Aid over-reliance

Strategies that help African nations free from over-reliance on foreign assistance must be urgently innovated. To that end, the government of Kenya must build ability to mobilise domestic funds. Because of its sustainability, domestic revenue should be one of the main sources for fiscal space expansion, thereby decreasing reliance on aid (Pfister, 2009:4-17). Kenya has been dependent on foreign aid for capital and social investments as presented in Figure 3 below **(**Foreignassistance.gov, 2018).

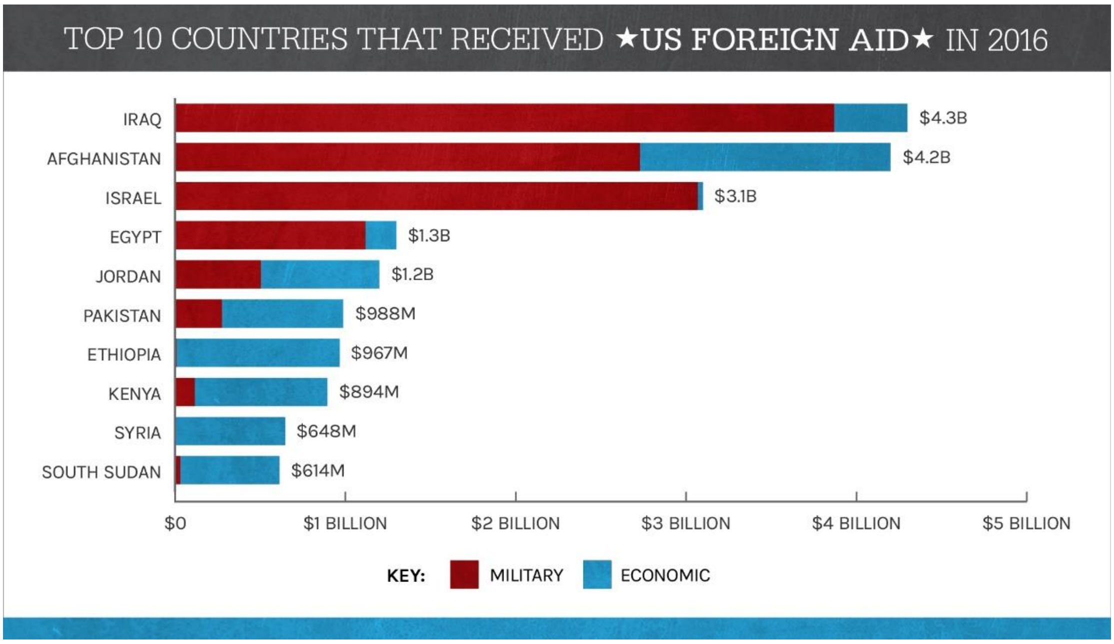


Figure 3.1 Foreign aid from United States

Source: Department of State (United States)

3.4.3 Investment climate and entrepreneurship

Economic growth and a country's investment dynamics are mainly affected by fiscal policies. In order to manage and develop in tax systems, there is need for transparency. Developing nations often have complicated fiscal systems that dampen the business environment and impede development opportunities. Numerous surveys, including OECD research, indicate that increasing the total tax obligation can decrease growth. All in all, good fiscal strategy surges the business climate, promotes global trade, innovation and boosts economy growth (Pfister, 2009:4-17).

In order to attract foreign investments, African countries face strong competition in relation to corporate income tax. In sub-Saharan Africa, fiscal incentives are now used more widely compared to the 1980s, as more than two thirds of Africa's countries provide tax holidays that attract investment. The creation of export zones with tax holiday opportunities has also risen. The IMF notes, however, that the developing countries often have tax incentives that do not necessarily increase investment rates if they are not coupled with other business environment policies, such as infrastructure (Pfister, 2009:4-17).

The probable Foreign Direct Investment (FDI) reaction to the reorganisation of the host tax system relies heavily on a wider spectrum of circumstances in the host nation. Indeed, with low taxation as an instrument to attract capital, some surveys indicate that tax is less essential than infrastructure as a location variable. It should be pointed out that tax incentives, financial subsidies and legislative exemptions aiming at attracting foreign investors will not replace suitable overall policy initiatives (Pfister, 2009:4-17).

In this respect, it is important not to rely heavily on indirect taxation, e. g. tariffs, VAT and export taxes and royalties. In a select number of African nations, indirect taxes create up most of the tax income. Kenya might recommend simplifying income structures by a fixed tax level, such as the 20% fixed commercial tax level passed by Egypt, to enhance revenue administration and distribution, as well as decreasing subsidies. This is in line with the latest changes in other fields of the business environment, as Mauritius and Rwanda have demonstrated. Simplified tax systems can also assist in flawless calculations of capital equity (Pfister, 2009:4-17).

In Kenya, tax schemes are still complicated, despite latest changes. Some tax legislation is uncertain and manuals do not exist for scrutiny, which leaves tax-enforcers too much discretion. For example, revenue officers may be discrete about significant choices, such as those relating to tax exemptions, tax liability determination, audit choice and disputes. Kenya, for example, was aiming to reduce tax burdens on both formal and informal businesses by introducing a single business permit (SBP) license in 1999. In reality, 17% of domestic revenues were rapidly lost relative to 7% loss of pre-single business permits. Recent reforms to simplify the SBP were designed to cut the costs of companies by an estimated USD 11 million annually. That shows that administrative viability is ultimately still a key consideration in any estimate of fiscal policy (Pfister, 2009:4-17).

Economic formalisation is generally within the scope of any fiscal policy. Much of the African economy comprises the informal sector. Being outside the tax net prevents formal financing and credit schemes for African small business community, which is essential for growth and innovation. The elevated VAT-registration limit is an impediment to the formalisation of small and medium-sized enterprises (SMEs) in Africa. The choice of whether or not small businesses pay taxes is therefore driven by a simple cost-benefit analysis (Pfister, 2009:4-17).

The KRA tax system's primary objective should be to promote economic growth and development. The fiscal policy should therefore stimulate and encourage investment and economic growth above all else. The tax policies and reforms within the informal sector should be tailored towards encouraging and inspiring investment and entrepreneurship for economic gain (Onyeka & Nwankwo, 2016:156-160).

3.4.4 Good governance

Effective fiscal management is underpinned by effective governance, particularly since taxation provides an opportunity to enhance government accountability to citizens. An effective and efficient tax administration is a key component of a capable state. A strong tax regime also promotes good governance (Pfister, 2009:4-17).

In general, good governance is benchmarked by a reasonable and clear tax scheme that is free from bribery and is governed by the rule of law. Co-ordination between the central and local authorities is also crucial in administering tax policies. Improved cooperation of tax policy issues between central and local authorities as a cornerstone of excellent economic policy would indeed have beneficial effects on other policy areas. This is another justification why taxation is an integral component of the structure for development policy (Pfister, 2009:4-17).

Taxation can serve to integrate citizens into the formal economy, enabling the provision of state benefits such as pensions, unemployment insurance and the protection of workers. This is especially crucial to Africa because the narrowness of the fiscal base has a serious impact on the tax rate enforced on the comparatively small formal sector. A significant frontier for African policymakers is the expansion of tax policy while offering renewed infrastructure and other public services in return. Some developing countries have corruption-affected tax administrations, poorly trained and poorly paid officers. Improving income efficiency will include significant improvements in tax management through stronger service delivery; taxpayers' education; effective use of automated systems; stronger tax administrations ' collaboration against tax evasion and active tax planning; and reinforcement of audit and capacity of human resources (Pfister, 2009:4-17).

Kenya faces high levels of inequality in terms of income irrespective of relatively high level of democratic governance. There are low satisfactory and confidence levels on the quantity and quality of goods and services by government (Ali *et al.*, 2014:829).

3.4.5 Overreliance on tax

Except for nations like the UK, the US, France and several others, taxation appears to be the primary source of economic backing in the majority of nations. Every other country almost looks to tax revenue as the ultimate public service provider. It is high time that Kenya government diversify sources of government revenue. For instance, in China and India they employ a wide array of revenue generating options. However, the nature of the economy and administrative capacity must be put into consideration, every country is unique. interventions may augment or constrain revenue generating capacity. In most instances the constraints result in governments relying heavily on a few tax instruments, often indirect in nature, which could create economic distortions and have serious welfare consequences (Abiola & Asiweh, 2012:100).

3.4.6 Dilemma of equity and equality

Equity, equality and simplicity are characteristics of a good tax system. These principles still hold today and even act as a guide for policy formulation. However, it is virtually impossible to accomplish everything within a single tax strategy; hence the proposition that there is no fair tax. This is because a tax that is effective could be unfair. An efficient tax may not necessarily be considered fair or one considered fair may not be effective (Abiola & Asiweh, 2012:101). Kenya Revenue Authority has opportunity to improve the fiscal basis and the collection of revenue. In order to achieve important tax compliance, citizens must be segregated and appropriate care and intervention taken (Karingi & Wanjala 2005:5).

The rigid tax policies and laws of the government regulating the formal sector while keeping the informal industry unregulated give the informal economy an undue benefit. For example, if the government guarantees equal and fair handling, by ensuring that the VAT system registers all informal businesses, the market for both formal as well as informal businesses would be level. Both would compete for business opportunities while the government would access full revenue through the KRA. If the informal and formal income of staff were taxed by the revenue authority, tax fairness would be achieved. There are other overwhelming reasons, apart from maximising revenue, for the KRA's efforts to regulate the informal sector to achieve compliance (Mpapale, 2014:8-10).

3.4.7 Poor tax data quality

In the quest of a broader tax base and formalisation, poor quality of basic data for the optimal taxation and tax models have also been detrimental (Moyi & Ronge, 2006:11-38). In 2018 KRA admitted to having on its database, 8.1 million taxpayers, out of which only 2.9 million had proficient records, representing 36 percent of taxpayers. E-Government Development Index (EGDI) presents the state of E-Government development of the United Nations Member States. It presents E-government development at the global and regional levels. The EGDI includes access features like the level of infrastructure and education to reflect how a country utilises technology to encourage access to and inclusion of its people. Kenya is a **middle** EGDI country. The EGDI is categorized as **very high**, **high**, **middle** and **low** (United Nations,2014).

3.4.8 Adverse politics

An unfavorable political environment not conducive to reasonable tax strategy could deter major tax reforms. The political elite with high personal income, wealth and property can use their economic influence to oppose taxing on property and wealth. These difficulties discourage the establishment of an effective and efficient tax scheme (Moyi & Ronge, 2006:11-38). In order to promote continuing modernisation initiatives, the KRA is also attempting to introduce a cultural change programme. The purpose is to promote new cultures, attitudes and behaviour, by focusing on the people aspect of change and by strengthening environmental issues for employees (Revenue.go.ke, 2016).

3.4.9 High income tax

Corporate and personal income taxes create distortion. In some nations the system of taxation is designed solely to generate income and has a detrimental impact on the economy. The tax regime in some nations is organized only in the direction of income. The government cannot merely levy a nation to affluence; it does not boost economic development. Just as tax income is essential for a country, it is still hard for many individuals to honor their fiscal duty. Nobody likes to pay tax but for social welfare taxation is necessary (Abiola & Asiweh, 2012:100). Corporate tax has had totally no impact on the operations of the informal sector as an income generating policy. The tax instrument is designed to cover formal companies with a properly defined management and reporting structure (Mpapale, 2014:12). PAYE is an organisation's tax system by which the employer is expected to act on behalf of the government to transfer a corresponding amount of tax on compensation for the employee's services to the employer to the tax authority. Therefore, the PAYE strategy has not introduced the actors of the informal economy into the tax loop, in that only workers in the formal sector are recognized and those non-registered are excluded (Mpapale, 2014:13).

3.5 Summary and deductions

Over the years, the Kenya tax administration has been constantly reformed. These changes included legislation, policies, administrative and internal measures. The most remarkable of these was the establishment in 1995 of a semi-autonomous tax administration unit.

The changes to Kenya's tax administration did not show a visible approach, policy or methodology. The fiscal reform approaches taken have been inconsistent. It has been hard to increase resources to satisfy government requirement for products and services because of the costs of implementing a semi-autonomous tax scheme and the informal aspect of much of its financial operation.

Developing nations usually have a small tax base, and the income tax is applied to a comparatively small proportion of the population. In order to broaden the tax base and take a large portion of the population into the formal economy, and simultaneously to reduce the over-reliance on international and volatile capital inflows through foreign aid, tax reform must be encouraged. In all measures of tax policy, administrative effectiveness continues to be a key consideration.

An assessment of the variations and challenges in taxpayer compliance within the revenue authorities and agencies in different regions and countries in the world, proposes that a blend of administrative, economic, social and political interventions are necessary for Kenya to attain optimal revenue generation from its informal sector.

It is therefore critical to determine whether Kenyan reforms follow an identifiable and measurable process.

Chapter 4 provides in-depth analysis of advances necessary for Kenya's informal sector revenue collection to promote public value.

Chapter 4: Analyses of advances necessary for the collection of informal sector revenue to enhance the public value

4.1 Introduction

The purpose of this chapter is to provide an in-depth analyses of advances necessary for informal sector revenue collection to promote public value. The analyses cover the causes for informal sector tax evasion in Kenya. The study also examines budget gap in Kenya based on statistics in the 2015/16–2017/18 budget reports. Figure 6 investigates the composition or sources of tax revenue and the effectiveness of diverse tax instruments in informal sector taxation. Lastly, the matrix in Table 4 analyses some challenges and interventions necessary for tax reforms in Kenya.

4.2 Literature study and content analysis

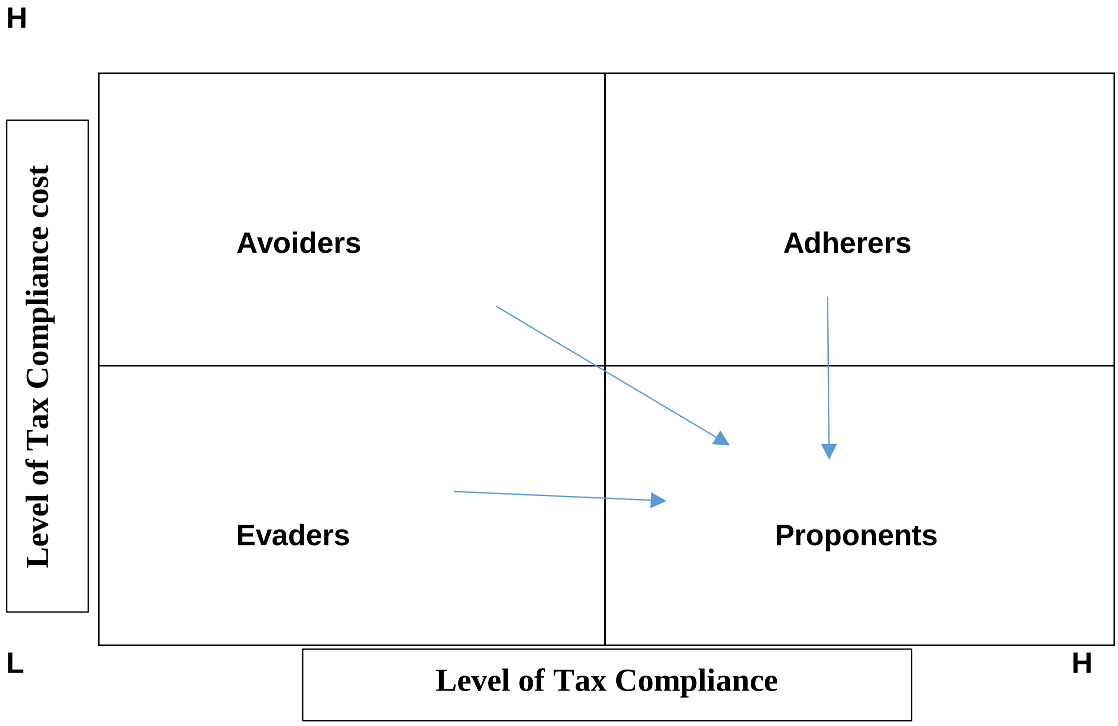
Before dissecting the theme of this chapter, it is imperative to highlight the terrain of literature that informed this study. Of equal importance is a short methodological explanation in this study. As mentioned in Chapter 1, the primary objectives of this study were (i) to provide introduction to informal sector and taxation in Kenya; (ii) to understand the informal sector and taxation: A Literature Study; (iii) to critically review characteristics and delimitations of the Kenyan tax system; (iv) to analyse advances necessary for informal sector revenue collection to promote public value; and (v) to progress results, conclusions and recommendations. The following research question informed this study: How does the income tax system structure ensure informal sector contributes equitably to revenue generation and public value enhancement?

4.3 Literature study

The literature study was meant to provide appropriate response to the research question through rigorous literature interrogation. From the scrutiny of debates of the various theories, economic deterrence theory emerged as a key causal variable of tax compliance or non-compliance by the informal sector. This theory posits that the choice on compliance by taxpayers is based on evaluation of costs and benefits. Taxpayers consider the compliance benefit vis-à-vis compliance costs. Procedural non-compliance results from non-compliance due to tedious and elaborate tax payment processes. When compliance with laws and processes is time-consuming and resource-consuming, only a few informal entrepreneurs are prepared to comply. Compliance with and non-compliance with tax commitments is the consequence of political, legal and administrative actors' choices as well as taxpayers behaviour. A key contributory variable for people's choice to participate in the informal economy is also the provision and, in particular, the quality of public goods and services. This suggests that tax non-compliance is not just a loss of revenue, but also detrimental for public value. A focus on the tax non-compliance behavior of informal sector is critical when addressing weaknesses in tax administration.

The researcher developed the following typological theory to support this causal hypothesis showing that low compliance costs enhances and improves tax compliance for the public good.

Figure 4.1 Typological theory of informal sector tax compliance



Avoiders have low motivation in complying with tax obligations and will opt for avoidance citing high cost of compliance.

Evaders are those non-compliant irrespective of low cost of compliance leading to loss of revenue and affecting provision of public value goods and services.

Adherers are exposed to high cost of compliance and still exhibit high level of compliance. These are likely to be multinational companies that can afford to comply irrespective of the costs because these costs can be passed on to their customers.

Proponents are the taxpayers that experience low compliance cost hence highly comply with tax obligations. Ideally, these are informal sector businesses because they usually prefer lower business costs. Tax non-compliance in the informal sector is an outcome of a cost-benefit decision. The researcher proposes that when implementing tax policy reforms, KRA should consider implementing this theoretical concept.

4.4 Research methodology applied

This research follows a qualitative method and has been carried out using published literature, theories, concepts and numerical analyses. In order to determine the potential implications of choices and behaviour, secondary data were collected and analysed. Comparison of distinct theories and methods used to enhance tax collection from the informal industry was also used in the comparative and cross-sectional study. The research was performed to maximise the advantages of both qualitative and quantitative methods by using methodological triangulation.

4.5 Content analysis

The analysis covers the causes for informal sector tax non-compliance in Kenya. It also examines Kenya's budget deficit using Development Initiatives report, Based on statistics in 2015/16–2017/18 budget documents. It further investigates the composition or sources of tax revenue and the effectiveness of diverse tax instruments in informal sector taxation. Lastly, the matrix analyses sample interventions necessary for tax reforms in Kenya.

4.5.1 Analysis of Tax evasion by the Informal Sector in Kenya

The findings as presented in Table 1.1 were determined through a study conducted by Ali *et al. (*2014).

In this Chapter the research paper focuses on analysing whether the variables presented in Table 1.1 in Chapter two are reason for tax evasion in Kenya.

An eight percent contribution to tax evasion was caused by the unfair tax system, because the informal companies in Kenya perceived the tax system as unfair and biased.

One in five informal businesses in Kenya had low tax morale due to exorbitant taxation.

The perception that the taxes are unaffordable was the most significant influence on compliance or non-compliance with tax liabilities by most informal companies.

Many individuals and companies have failed to meet tax obligations in Kenya because of the low quality and quantity of products of public interest and government facilities.

One out of ten government officials is corrupt, which has negative consequences, because most informal firms would encourage tax evasion by citing state officials' theft of revenue.

Kenya has high detecting ability and stringent tax violation laws; 98.5% of tax evaders felt that legal action would be taken against them if they were to be known.

4.5.2 Analysis of Kenya's budget deficit

The government budget balance necessary for spending on public goods and services (B_t) in a given year t depends on the government revenues (R_t) and expenditures (E_t) for that year:

Equation 4.1

$$B_t = R_t - E_t$$

If Bt>0, then there is a budgetary excess for that year, because it is more tax collected than spent by the state. If Bt < 0, a budget deficit indicates that the state has invested much more than taxation has generated.

Equation 4.2

$$B_t = R_t - E_t$$

$$B_t = 1.7 - 2.29$$

$$B_t = -0.59$$

$$B_t < 0$$

An analysis of Figure 1.1 using the formula above shows that in 2018 the Kenyan budget suffered a deficit because $B_t < 0$. The government spent more than it generated through taxation. A positive government budget balance was necessary for spending on public goods and services (public value promotion).

4.5.3 Analysis of effectiveness of varied tax instruments in informal sector taxation

In Chapter 2 it was indicated that tax revenue in Kenya was estimated to be at 20.1 percent of GDP in 2011. Although this proportion was much greater than in most African nations, Kenya's tax burden allocation was very irregular, leaving a significant part of the economy untaxed. It raised a 3 percent flat rate on turnover to substitute both income tax and VAT.

Significant attention was given to creation of a simplified ‘single permit’ for small businesses, resulting in improved conditions for small businesses and encouraged some degree of formalisation. However, KRA has no record for the bulk of the informal businesses in Kenya, hence no reference in the authority’s system. Efficient taxation of revenue is becoming progressively hard.

Recent study shows that newly registered firms have, in some cases, continued to be subject to corruption and harassment by public officials. However, with limited follow- up research, the long- term impact of reform has not been determined.

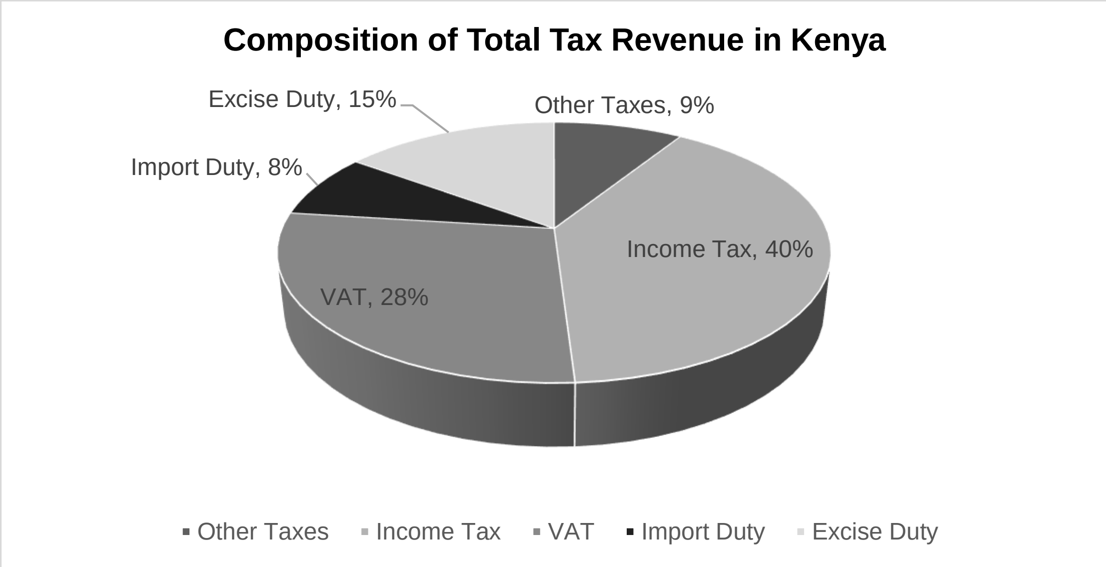


Figure 4.2 Composition of total tax revenue in Kenya

Source: KRA

In Chapter 3, the effectiveness of income tax (corporation and PAYE), VAT, withholding tax and turnover tax are discussed. It was shown that despite the focus by the KRA in generating revenue through all the above mentioned tax heads in, turnover tax (Other Taxes) presented greater efficiency. It is the best way to broaden the tax base in the informal industry.

4.5.4 Analysis of challenges for tax policy reforms in Kenya

Table 3.1 Challenges for tax policy reforms in Kenya

	Institutional / Administrative	**Economic**	**Social**	**Political**
Tax evasion	√	√	√	√
Over dependence on aid		√	√	√
Investment climate & enterprise		√	√	√
Threatened good governance	√			√
Overreliance on revenue by government	√		√	√

Equity & equality dilemma	√	√	√	√
Poor quality tax data	√			√
Unfavourable politics				√
High corporate and income tax	√	√		√

The Table 4.1 above summarises the challenges that the KRA faced in tax reforms. The challenges were institutional, economic, social and political. Most of the limitations in Chapter 3 were beyond the institution and/or administration of the KRA. The delimitations were as a result of combined institutional, economic, social and political reasons.

Over the years, Kenya's taxation system has been subject to several constant changes. The reforms however were mostly institutional. There were also some economic, social and political reforms. The most notable were institutional reforms within the KRA administrative arm. The reforms lacked discernible synergy and had numerous inconsistencies.

The analysis in Table 4.1 indicates that the interventions for tax reforms in Kenya necessitate recognition of interrelation, interconnection and complexities of challenges within informal sector.

There are multiple facets to the effectiveness of fiscal reforms to promote public value. The finest strategy for sustained growth is stable and transparent institutional, economic, social, political and legal framework and integration of international best practice.

4.6 Summary and deductions

The effectiveness of tax reform in promoting public value, investment and economic growth is generally uncertain. A robust and consistent administrative, cultural, financial, political, legal and regulatory structure and implementation of a tax scheme in line with global standards are the best approach for the sustainable advancement. Some objectives, such as those that encourage regional development, are more justifiable than others as a basis for generating more revenue, especially from the informal economy. Not all fiscal reforms are equally effective. Administrative interventions have the most comparative merits, followed by social, economic and political factors which serve to complement administrative efforts. A consideration of both internal and external environments is essential when developing tax strategies and reforms. Many factors that have an impact on tax reforms and, in turn tax compliance by taxpayers is considered in this chapter. Therefore, when administrative and managerial arrangements are made relating to tax issues and how they are applied, more successful results can be achieved if the sensitivity of taxpayers is taken into consideration.

Chapter 5 provides a summary, recommendations and conclusions regarding the study.

Chapter 5: Proposed recommendations for tax reforms in the informal sector

The final chapter consists of the presentation of analysed and summarised research findings. Recommendations are made on how to improve informal taxpayers' perceptions and conclusions on whether the study meets the research objectives. The study limitations are also highlighted.

5.1 Introduction: research findings

Tax administration and policy should be among the greatest concerns for any developing country. Efficiency in its tax collection procedures and a fully compliant tax base are the targets of tax administration. From the propositions in the previous chapters, Kenya needs to urgently address the problem of tax evasion in the informal sector which is not only a threat to the economy, but is also slowly affecting provision of public goods and services necessary for public value.

The state and its officials are able to take several measures to enhance compliance.

5.2 Improving outcomes

This last section discusses a series of efforts to reform tax systems that encourage compliance for public value augmentation.

Figure 5.1 The causal and outcome hypothesis

5.2.1 Institutions and technological incentives

Although policy choices are critical, the success of any tax system is based on the efficiency of fiscal administration implementation. The tax administrators are a powerful and critical instrument because they can block or sabotage the implementation of reform.

Although the policy, administrative and technical changes are well-defined, there has been comparatively restricted attention to the politics of that reform. This partly represents the constant uncertainty regarding the advantages of extending informal sector taxation. There is strong support for the need to reform and strengthen current procedures so that they are reasonable and more effective in attaining informal sector taxation as a public value instrument. Politics, however, is a key catalyst for its capacity. The latest study results reveal that the absence of political will is also a significant barrier to informal tax reform. These proposals are here developed. These factors that may shape incentives for firms to formalise.

5.2.1.1 Privatisation of tax administration

Privatisation is generally a strong incentive for collection maximisation, but in reality is susceptible to corruption while not doing much to promote negotiation, voluntary compliance or more productive interaction between state and society (Joshi *et al*., 2014:1341). The primary reason is that corruption is reduced and the method of income collection is simplified. In some instances, however, outsourcing has been costlier and not less prone to bribery (Fjeldstad & Rakner, 2003:17-20). KRA can also delegate collection of taxes to trade unions and other informal firms' associations (Joshi & Ayee, 2009:48-76).

5.2.1.2 Disruptive FinTech reforms

It involves using FinTech, for example, mobile phones to fulfill tax requirements. In Kenya, there is an advantage of mobile phone money transfer (Mpesa) administered and managed by Safaricom, one of the major tax compliant telecommunication firms. Money transfers using this service is the main mode of money transfer for a significant part of the informal sector. The Kenya revenue authority can work with Safaricom and other telecommunication service providers to access every transaction by a registered phone holder and/or business. The mobile phone money transfers should be limited to business transactions that are tax compliant. The government should work together with other stakeholders through the Communications Authority of Kenya to include registration by the revenue authority as a requirement and qualification for any business enterprise to use the mobile phone money transfer services. This should definitely make a significant impact on revenue generated by the taxman. However, this should be achieved in an appropriate legal framework (Ndaka, 2017:84).

5.2.2 Institutions and economic incentives

A major area of research considers formalisation to be a rational choice. Enterprises adopt rational and informed decisions that support their goals. These firms formalise when the economic advantages of formalisation exceed the cost (McCulloch, Schulze & Voss, 2010:18-24).

Consequently, in order to convince the informal sector regarding formalisation and entering the tax net may depend on addressing the broader costs and benefits of formalisation (Zinnes, 2009:32-40).

5.2.2.1 Periodic tax reforms

To achieve a budget surplus for financial development, job creation and fair tax governance, the tax officials must review fiscal measures periodically to enhance fiscal strategy models. Periodic reforms provide opportunities to re-examine existing policies to determine strategies for increasing revenue without jeopardizing economic growth. In the fight against tax evasion and tax fraud, continuous consultative interventions are essential to improve compliance (European Commission, 2014:1-25).

5.2.2.2 Fiscal decentralisation

This scenario relates to a transfer of revenue collection from the central government to the local district administration for better proximity with informal businesses. This aims to reduce compliance associated costs and improve tax collection effectiveness. Fiscal decentralisation also gives independence to local counties, which are therefore fully responsible for collecting and spending income. Financing their own developmental agendas ensures that the districts maximise efforts to access and extract full potential from the tax bases, which includes income of both formal and informal sectors (Corbacho *et al*., 2013:80).

The tax reforms must determine which revenue functions and agencies that are best centralised, those that should run concurrently and which are better placed under the scope of decentralised levels of government (Onyeka & Nwankwo, 2016:161-163).

The local governments have no influence on national economic policies and thus require relatively stable sources of revenue (Fjeldstad & Rakner, 2003:26).

5.2.3 Institutions and social incentives

This approach stresses the involuntary nature of informality, as opposed to rational calculations of the cost-benefit approach (Joshi *et al*., 2014:1326-1339).

5.2.3.1 Absorptive capacity consideration

The absorptive capacity is the rate at which people are responsive and receptive to interventions and/or changes instituted by government. No one-size alternative to combat non-compliance is available. Tax reforms and strategies rely on a particular and distinctive income distribution framework in a country. A country-specific and responsive strategy to tax failures is an efficient one. It is imperative for tax reform to match the absorptive capacity of a country when developing policies for tax reforms. Countries that exhibit low absorptive capacity require less ambitious reforms, otherwise the effort will fail, but if the absorptive capacity is high, the reforms will be successfully embraced by the citizens (Siehl, 2010:25).

5.2.3.2 Equity and equality

Tax reforms require serious consideration to achieve equity and equality. A better tax system is one that supports a tax burden that is directly proportional to the level of income earned by the citizens in the labour market. The progressive system of taxation is fair, but it can only be effective if the tax base is broadened (European Commission, 2014:107). Taxpayers meet tax liabilities as soon as they think that they all conform with the same tax rules and requirements. When citizens perceive equality and fairness in how tax obligations are administered by tax authorities they are more likely to be tax compliant themselves (Ali *et al*., 2014:829-830).

5.2.3.3 Collective action and state–society interaction

In order to encourage voluntary compliance by the informal sector, tax policy formulation should be undertaken after due consultation and collaboration with all the stakeholders. The gap between the taxpayers and the revenue agencies usually is so wide that policies are made and forced down on the taxpayers without due consultation. Tax policies should be welcomed by all taxpayers for there to be good tax administration. Besides, the involvement of all stakeholders by government would be perceived as a form of openness and sincerity, thereby reducing the problem of trust which has bedevilled tax administration. A public-private partnership between government and informal sector businesses is key if full trust and compliance by the taxpayers is to be achieved. The informal sector needs to be engaged in the development of strategies that influence both individuals and their companies. Although the formal sector is usually well known and policymakers deal with their complaints, the informal sector is not contacted because they are not formally registered. Like every other profit-oriented business, the structure of tax administration should be customer oriented (Kanyi, 2014:616-620).

5.2.4 Political and social incentives

This final approach complements the ones outlined above. This approach seeks to focus additional attention on politics and the nature of the relationship between the state and informal sector operators (Daly & Spence, 2010:15-21). Over and above a simple cost-benefit analysis, formalisation policies need to acknowledge and address the three key strategic problems of information, credibility and coordination (Daly & Spence, 2010:15-21).

The dissemination of information is essential because the informal sector taxpayers do not generally know of the programmes, or comprehend the formalisation criteria. This is a challenge that is unique to every country although quite prevalent in most developing states. There is a significant need for states to adopt strategies that focus on outreach and taxpayer services (Jaramillo, 2009:23-28).

Cooperation is important because the interests of companies are only to formalise when they are fairly sure that a large proportion of other non-partisan companies that compete with them do so. In Ghana, the state negotiated on taxation issues with informal sector operators through associations, this improved administrative effectiveness and compliance (Joshi & Ayee, 2009:48-52).

Willingness and ability by the state to negotiate and bargain with multiple small collective businesses and actors in the economy is also necessary in achieving collective action toward informal economy taxation. Moreover, over and above collective bargaining, reform champions who wield sufficient political influence are necessary to overcome entrenched resistance, otherwise successful reform is unlikely (Heredia & Schneider, 2003:17-26).

5.2.4.1 Government legitimacy

The state should provide the informal sector a reason to bear taxes, through instituting policies that make it possible to gain from the revenue received by government. By this, people would give more when they see what their taxes are doing for them (Ndaka, 2017:84).

5.2.4.2 International and regional cooperation

International and regional attempts have been made to enhance domestic fiscal changes. However, actions at global stage must be followed at national stage by suitable domestic policies. Domestic tax matters and international modes of tax evasion, for example transfer-pricing, cannot be unilaterally resolved by a given country. Taking into account the small income in many developing countries, the income deficit owing to tax incompliance, mainly by the informal sectors, caused serious issues when financing vital domestic and global public value programmes.

Global networks are essential to data sharing, and best practices strategy in order to enhance global and national collaboration in tax policies. Regional networks are also necessary as they help to exchange best practices between emerging and advanced nations (GTZ Sector Programme Public Finance, 2010:30-33).

6 Summary and conclusions

6.1 Suggestions for Future Research

Composite datasets that encompass all taxable facilities in informal sector often produce impartial outcomes. Thus, while the findings demonstrate strong degree of confidence in the link between tax compliance by informal sector and tax income generation, there is need to interrogate further the non-compliance by formal sectors. Better knowledge of certain impacts would involve the individual examination of formal business activities that transpire through the informal sector. Finally, implementing strategies that dramatically deviate from its origins often forces administrative organs to change their focus rapidly and frequently haphazardly, creating organisational turmoil and significantly disadvantaging administration. Finding the picture of a fiscal administrative structure capable of adapting methodically and effectively to fiscal policy crises would be highly fascinating.

6.2 Conclusion

This study was undertaken to assess income tax from the informal sector as means to afford enhanced public value in Kenya.

The aim of this thesis was to review and assess study centred on future income development and the advantages of informal sector fiscal governance; to consider appropriate approaches to tax informal sector companies and to explore organisational and policy environmental obstacles to appropriate reforms. The main focus of this thesis was the analysis of the studies. The ultimate interest was not primarily to advocate for or against expanded taxation of the informal economy, but to consider how these systems could be made more effective and equitable.

The research objectives for this study were examined. Chapters 1 and 2 provided introduction and understanding of informal sector and taxation. Chapter 3 outlined characteristics and delimitations of the Kenyan tax system. Analyses of advances necessary for informal sector revenue collection to promote public value were also presented in Chapter 4.

The existing literature suggested that the effectiveness of tax reform in promoting public value, investment and economic growth is generally questionable. Therefore, best strategy for sustained promotion of taxation of informal sector and public value is to provide stable and transparent institutional, social, economic, and political framework and put in place a tax system that accommodates the views of all stakeholders and one that is economically viable.

The last chapter has also presented the main summary of the research findings, and has concluded with useful suggestions for future research. Conclusions regarding whether the study met the research objectives are drawn and recommendations are made on how to improve perceptions held by taxpayers in the informal sector, and the limitations of the study are also highlighted.

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